Affordable Housing for All Australians

A submission prepared by the Property Council of Australia for the Productivity Commission October 2003

The Voice of Leadership

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Executive Summary

Many potential first home buyers have been priced out of the residential market, and they're not alone.

The high cost of housing is forcing Australians to scale back their aspirations, while others can only realise their dreams by taking on more debt.

This state of affairs has been caused by a *systemic* failure of public policy making. It is a problem that has evolved over many years, despite frequent warnings by those close to the marketplace.

These public policy failures have *artificially* raised the cost of housing.

At its simplest, many segments of the nation's housing markets are experiencing a *structural* imbalance between demand and supply.

Demand for housing is strong, due to:

- low interest rates;
- demographic trends (such as net population growth and higher household densities);
- attractive relative property returns to investors compared to other asset classes; and,
- aspiration.

However, supply can't demand can't keep pace with demand due to:

- poor strategic planning;
- an inefficient taxation framework;
- poor allocation of infrastructure;
- poor development assessment processes;
- poor understanding of the different housing consumer segments that require policy attention – the welfare dependent, low income earners, new entrants etc; and,
- ignorance of capital markets solutions to capitalising the supply of targeted affordable housing.

This is why the Property Council contends the balance between supply and demand has been unhinged by systemic policy failures.

The result is artificially higher prices. Which means the community is bearing a premium for misconceived public policy settings.

The Property Council recommends several solutions designed to rebalance supply and demand after removing policy distortions. It proposes governments:

- develop comprehensive strategic plans for all major population areas, including schedules for releasing appropriately zoned land;
- address the urgent need for an efficient allocation of infrastructure across the community;
- reform property related tax systems;
- re-confirm and improve negative gearing arrangements;
- reform development assessment systems; and,
- develop targeted supply-side affordable housing solutions for low income earners using capital markets funding structures and tax incentives.

Introduction: Logic of Submission

This submission:

- scopes the pricing issue for first home buyers and places it within a broader public policy context;
- identifies the importance of housing for the community;
- identifies desired economic, social and environmental outcomes;
- analyses the causes of higher prices;
- identifies barriers to an efficient market place; and,
- proposes solutions to overcome each of these barriers.

The submission focuses on solutions, rather than a detailed statistical examination of the current situation.

Statements of industry facts and figures are well handled by other organisations and are cited where relevant.

The submission has been prepared by the National Residential Development Committee of the Property Council of Australia, chaired by Denis Hickey, CEO Residential Development, Stockland.

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Chapter One: The Property Council of Australia

The Property Council of Australia welcomes an opportunity to participate in this Productivity Commission inquiry.

The Property Council comprises the leading developers, financiers, owners and managers of investment property in Australia. These members currently own more than $300 billion of domestic assets.

In addition, the Property Council's members include all major professional and trade services suppliers.

An increasing volume of master planned and urban residential development is being undertaken by major firms with strong balance sheets.

Institutional investors are also becoming more interested in what Americans call `multi family' residential development.

Over the past decade Australia's commercial property markets and the mainstream capital markets have become increasingly integrated. This trend has fundamentally changed the way the sector operates – from financing to risk management.

An increasing portion of the residential property sector will follow this pathway over the coming years.

The Property Council is convinced that most of the issues relevant to the housing affordability problem are a subset of a broader systemic policy failure that impacts across the entire spectrum of property investment in this country.

Considerable resources have been devoted to analysing these problems and developing solutions.

In this submission, we apply our analysis and suite of solutions to the housing affordability issue.

Chapter Two: Summary of Recommendations

The Property Council has provided 21 recommendations for consideration by the Commission. These recommendations are detailed in Chapter 6 of this submission.

This chapter summarises the **key** recommendations proposed by the Property Council.

Big Picture – A National Approach to Planning

Housing solutions for first home buyers will be more effective within the context of a broader more appropriate planning framework.

The Property Council recommends The Council of Australian Governments resolve to develop a national strategic planning framework.

As part of this interlinking strategy, states should:

- Establish programs for releasing serviced land; and,
- Sequence the provision of infrastructure to economic and social public policy programs.

Forecast of Construction Activity

Since 1997, there have been no reliable, readily available, low cost housing forecasts in the public domain.

The Property Council recommends the Construction Forecasting Council be funded to forecast residential building activity.

Development Assessment

The Property Council recommends that all governments commit to the reform program recommended by the Development Assessment Forum (DAF).

In doing so they commit to a reform timetable that will see the harmonization of best practice development assessment systems by 2006.

Developer Charges, Taxes and Levies

The Property Council recommends;

- developer charges only be applied in line with the clear and transparent principles as outlined in recommendation 9 of this submission;
- new taxes and levies for funding infrastructure be rejected;
- governments adopt the findings of the Allen Consulting Group report on funding infrastructure; and,

- the timetable for reviewing taxes under the Intergovernmental Agreement be widened to include a review of stamp duty on residential conveyancing.

Negative Gearing

The Property Council recommends that the Federal Government re-affirm the importance of negative gearing in its current form.

Targeted Housing Measures

In order to improve the stock of affordable housing the Property Council recommends:

- the establishment of a body to oversee the introduction of innovative financing techniques in Australia;
- all governments ensure that the supply of affordable housing form a key component of planning control and development assessment systems;
- the rejection of inclusionary zoning which would force developers to portions of new development to qualifying low income earners
- COAG commit to an intergovernmental pilot study that tests the efficacy of private financing vehicles (including the establishment of a Listed Affordable Housing Trust) for low cost housing;
- an immediate audit be conducted by all governments on the public housing stock and an assessment should be undertaken as to what assets can be privatised; and,
- community housing groups take over the control of the bulk of targeted affordable housing.

Chapter Three: Scope of the Submission

The declining affordability of housing for first home buyers is part of a systemic problem that applies to the entire property market.

The Property Council's thesis in this submission is driven by the following logic:

1. demand for housing is strong due to several economic, demographic and cultural factors;
2. supply cannot meet demand due to a broad set of public policy failures, specifically in relation to planning, regulation and tax regimes;
3. there are minimal market failures in relation to the efficiency of the private sector's production of housing stock;
4. the mismatch between strong demand and inadequate supply is inflating asset prices; and,
5. consequently, the key to increasing access to affordable housing lies in remedying the systemic policy failures.

The Property Council recognises the mismatch between supply and demand occurs in unique ways across Australia.

The Property Council also recognises that the incidence of declining affordability varies by different sections of the community. The Property Council identifies the community market segments for which solutions are required as follows:

- the homeless;
- the welfare dependent;
- new entrants – first home buyers;
- lower income earners; and,
- the broader community.

Clearly, some of these categories overlap.

We propose that:

1. there are core solutions that need to be applied to all market segments in all jurisdictions and at all levels of government; and,
2. specific programs are required (in addition to the systemic public policy solutions) for some market segments, notably those who suffer housing stress and new entrants.

Productivity Commission Inquiry into First Home Ownership – Terms of Reference

- Identify and analyse all components of the cost and price of housing, including new and existing housing for those endeavouring to become first home owners;
- Identify mechanisms to improve the efficiency of the supply of housing and associated infrastructure; and
- Identify any impediments to first home ownership, and assess the feasibility and implications of reducing or removing such impediments.

Particular attention should be given to the following matters as they affect the cost and availability of residential land and housing in both metropolitan and rural areas:

(a) the identification, release and development of land and the provision of basic related infrastructure;

(b) the efficiency and transparency of different planning and approval processes for residential land;

(c) the efficiency and transparency of taxes, levies and charges imposed at all stages of the housing supply chain;

(d) the efficiency, structure and role of the land development industry and its relationship with the dwelling construction industry and how this may be affected by government regulations;

(e) the effect of standards, specifications, approval and title requirements on costs and choice in new dwelling construction; and

(f) the operation of the total housing market, with specific reference to the availability of a range of public and private housing types, the demand for housing, and the efficiency of use of the existing residential housing stock.

The inquiry will also identify and examine mechanisms available to improve the ability of households, particularly low income households, to benefit from owner-occupied housing. This will include an assessment of rent and direct ownership subsidies, loan guarantees and shared equity initiatives.

Chapter Four: Desired Outcomes

The Property Council believes an efficient market will deliver housing to meet the community's needs.

Clearly such a housing market should:

- deliver a range of accommodation choices to meet the needs of different householders; however, low income earners should not be forced to find shelter in sub standard accommodation;
- deliver appropriate safety and amenity;
- be regionally distributed to where housing is needed – including proximity to jobs;
- serve the needs of both renters and potential owners;
- provide affordable housing opportunities for disadvantaged target groups; and,
- provide no barrier to those who wish to move from renting to ownership.

The housing market is a vital component of a broader sustainable community.

The UK government's *Sustainable Communities: Building for the Future* (Office of the Deputy Prime Minister, 2002), describes the features of such a community as follows:

- a flourishing local economy to provide jobs and wealth;
- effective management by local people in the planning, design and long term stewardship of their community;
- a safe and healthy local environment with well-designed public and green space;
- sufficient size, scale and density, and the right layout to support basic amenities in the neighbourhood;
- good public transport and other transport infrastructure, both within the community and linking it to urban, rural and regional centres;
- a well-integrated mix of decent homes of different types and tenures to support a range of household sizes, ages and incomes;
- good quality local public services, including education and training opportunities, health care and community facilities, especially for leisure;
- a diverse, vibrant, creative local culture, encouraging pride in the community and cohesion within it; and,
- a `sense of place'.

The Property Council contends that the market could generally meet these needs were it not for the distortions caused by poor public policy settings.

The exception is for the homeless, the welfare dependent and low income earners, where some form of public financial assistance is required to encourage investors to take development risks.

Consequently, in order to meet community expectations, the industry seeks reforms under the following broad headings:

Planning-Based Solutions
Big picture planning
Urban and regional development framework
Housing framework
Land release programs
Statutory plans
Building regulation
Sustainability
Development assessment
Tax and Infrastructure Solutions
Indirect taxes
Developer charges
Infrastructure funding
Negative gearing
Targeted Solutions for Market Segments
Capital Markets Vehicles
First Home Owners Grant

These solutions are explored in detail after an examination of market barriers provided in the next chapter.

Chapter Five: Market Barriers

Australians are being priced out of the housing market for the following reasons:

- there is an artificial shortage of serviced land caused by poor planning policy;
- statutory planning instruments send contradictory messages to the market particularly in relation to urban consolidations;
- the infrastructure needed to service housing communities is poorly allocated and inefficiently capitalised;
- governments charge inefficient and inequitable taxes that add to final home prices;
- poor governance mechanisms which delay projects due to inconsistent and contradictory development policy at the local level; and,
- the cost of inefficient development assessment process.

Barrier 1 Strategic Planning – the Big Picture

Planning failure in Australia is endemic.

Until recently governments failed to see strategic planning as important.

A 2002 report prepared for the Property Council by the Allen Consulting Group called *Recapitalising Australia's Cities: a Strategy in the National Interest*, noted that most public policy in this country is spatially blind.

Governments at all levels are in the business of making decisions about the provision of basic public services. Most of these decisions have spatial implications as most services are delivered through the built environment. Yet, economic and social planning is rarely tied to spatial planning.

In addition, the infrastructure that supports the built environment – roads, railways, water systems, telecommunications and the like, are crucial to the efficient and equitable distribution of these services. Infrastructure ties communities together and needs to be coordinated.

Good strategic planning does not mean planned or command economies.

Good strategic planning is simply an attempt to assist the private and public sectors operate at an optimal level. At its most basic, this is achieved by:

- efficiently allocating scarce public infrastructure resources;
- ensuring such infrastructure is integrated as far as possible;
- doing so to meet transparent economic, social, and increasingly, environmental goals.

Examples of poor planning can be seen in:

- ad hoc land release programs; and,
- communities where land is released without the appropriate supporting infrastructure.

The high price of homes in some parts of the country is one result of this policy failure.

Inadequate regional development programs are another symptom of poor strategic planning.

It is crucial that regional and rural growth be planned in tandem with urban (including metropolitan) development.

At present, the Melbourne 2030 strategy is the only attempt to realise the broad based planning dividends Australian communities deserve.

There are no state or territory wide plans, and no national planning strategy.

A copy of the Recapitalising Australia's Cities is attached at Annexure A.

Barrier 2 Land Supply

One symptom of poor strategic planning is the absence of land release programs accompanied by appropriate infrastructure servicing.

A large portion of demand is driven by demographic change (net population growth, space use trends and settlement patterns).

Sydney provides an example of the problem.

Forecasts are for Sydney's population to rise from 4.1 million to five million by 2026, which means Sydney will need to accommodate more than 40,000 people every year for 25 years.

In fact, Sydney's current annual immigration is nearly 55,000

According to Planning NSW, underlying demand is forecast at 27,000 dwellings per year. However, only 5,000 new lots will be released annually.

Industry players point out that at present the regime is struggling to deliver 1,400 new lots per year.

Another dimension of the problem arises from shrinking household sizes. Planning NSW has noted that 110,000 extra homes have been built simply to accommodate the same number of people.

NSW Premier Bob Carr has admitted the problem saying, "We've got a five-year backlog of housing…we're running out of residential land" (p3.3, *Bob Carr: A Self Made Man*, Andrew West and Rachel Morris.

Clearly, land supply in Sydney is tight.

South East Queensland (Australia's fastest growing region) has net migration of over 58,000 people per year. Again based on current housing trends over 24,500 new dwellings are needed each year to house this migration.

The Menzies Research Centre (MRC) has analysed those factors driving up housing costs due to land shortages.

In their *Prime Ministerial Task Force on Home Ownership*, the authors conclude:

"…our analysis indicates that there is an ever-growing divergence between the price of Australian properties and their underlying costs of construction. Importantly, this does not appear to be a manifestation of natural constraints on the supply of land, but rather a product of regulatory restrictions that artificially inflate the price of housing. Viewed differently, these limits on dwelling dispersion and the release of greenfield sites act as a burdensome tax on new building, which in turn leads to a mismatch between the accommodation needs of Australian households and the stock of available properties." (Page 302)

The MRC specifically examine reasons why the commodity price of housing is markedly greater than the marginal cost of producing it.

They note that in June 1985, the land component of the median Australian dwelling was $30,058. Taking account of inflation, the constant dollar value in 1993 is $103,306 – three times higher. In Melbourne, the increase over the same period is 418%.

The MRC analysis compares final house and building materials prices in all major capital cities. Apart from Hobart, a common pattern emerges: materials prices followed inflation (apart from the GST spike), whereas total home prices rose sharply over the past few years.

The MRC's finding in relation to the world class efficiency and stability of the construction industry, and its ability to deliver housing at low marginal costs had already been shown by a McKinsey and Co study in 1995, called *Growth Platforms for a Competitive Australia*.

Clearly, it is the **land costs** that have risen due to poor government land release programs for greenfield sites and restrictions on the development of brownfield sites.

Once again, this systemic policy failure translates into a premium for housing at all levels of the market, but which impacts most severely on lower income earners.

Barrier 3 Infrastructure and Levies

Another significant factor in the housing affordability equation is the levies applied at the development stage of housing construction.

These levies take a number of forms:

- developer contributions levied by councils to fund local urban infrastructure;
- direct infrastructure charges levied by utilities, such as water head works charges;
- new levies imposed by state governments to fund state-delivered transport infrastructure, such as the $15,000 per lot transport levy recently applied to four land release areas in western Sydney; and,
- new ad hoc levies for various specific purposes, such as the NSW Plan First levy designed to fund reform to the plan making system in that state.

While developer contribution arrangements have existed in most Australian jurisdictions for decades, recent years have witnessed a steady increase in the size of these levies.

This trend has been driven by a significant expansion in the baseline infrastructure these schemes are expected to fund.[1] In the 1970s the definition of local infrastructure merely included the reservation of land for open space. Now developer contributions are expected to pay for:

- local roads and road improvements;
- landscaping;
- lighting;
- cycle-ways;
- underground services;
- naturalised water cycle systems with ponds and lakes;
- developing dedicated land for recreational use;
- provision of community buildings;
- child care centres;
- regional recreation centres such as aquatic centres; and,
- a variety of other facilities and environmental improvements.

The result is that contribution rates are rising substantially, with NSW the worst offender. For example, Liverpool City Council in Sydney has levied developer contribution in excess of $50,000 per lot.

[1] Allen Consulting Group, *Funding Urban Infrastructure: Approaches Compared*, Report for the Property Council of Australia, August 2003, pp. 30-31

Who pays?

The vast bulk of these new and increasing developer levies are passed through to consumers (new home buyers). The consensus of economists is that almost all of any developer contribution is passed on to the ultimate consumer.[2] This is due to the relative inelasticity of serviced land, i.e. the relatively limited effect which changes in the price of serviced land has on demand for that land.

The 2003 Allen Consulting Group argues this has a wider impact:[3] When the price of new houses rise, so does the price of its close substitute, existing housing. Thus existing home owners are made wealthier while renters and prospective home buyers face increased prices for new homes.

It has been pointed out that since established homeowners generally have higher incomes than renters and first home buyers, a change from other funding mechanisms towards developer charges works against the even distribution of wellbeing and amenity.

Obviously, increased house prices that stem from the use of developer charges make it more difficult for people to afford a home. These increased costs occur at the time in people's lives when their finances are most likely to be stretched.

The economic impact of developer levies

The Property Council of Australia commissioned the Allen Consulting Group to undertake landmark research into the infrastructure funding options open to governments. The report, *Funding Urban Infrastructure: Approaches Compared*, found that developer levies are by far the most inefficient form of infrastructure funding available to governments.

The Allen Consulting Group undertook a global search of like economies and government structures (including the United Kingdom, Canada and the United States) and identified the following five funding options as the core categories into which all other funding options fall:

- government borrowing;
- general taxes;
- user charges;
- producer charges (i.e. developer levies); and,
- special purpose vehicles (such as public-private partnerships).

[2] ibid., p. 65
[3] ibid.

From a qualitative perspective, the report found developer levies:

- are ineffective – levies only have the capacity to fund small to modest scale infrastructure;
- are inefficient – levies have a highly distortionary impact on the economy and are the most inefficient method of funding infrastructure;
- are inequitable – levies are generally regressive:
  - levies are generally passed on to customers (home buyers and business tenants);
  - other industries which indirectly create a demand for a public good are not similarly levied (eg. car manufacturers are not levied to contribute to roads);
  - levies take no account of the fact that urban development generates revenue for governments through taxes and other charges;
  - often the infrastructure to be funded by such levies appears late or not at all; and,
  - often such levies are arbitrarily and unevenly applied;
- often provide an uncertain revenue base – delivery of the infrastructure item becomes dependant on levy income, especially problematic when property and construction cycles are in a downturn;
- have high administrative costs – complex standard setting and compliance evaluation are required and involve a high level of disputation and lengthy legal processes; and,
- have high compliance costs.

The quantitative analysis undertaken by the Allen Consulting Group produced even more striking results, confirming that developer levies are not only inefficient but are also harmful to the economy.

Among the funding options analysed by the report, developer levies performed the worst in terms of boosting GSP, employment, capital stock and consumption.

Using developer levies to fund $5 billion in infrastructure over five years would generate just $0.8 billion in GSP compared to the $13 billion boost to GSP that government debt financing would create.[4]

That means developer levies are thirteen times less efficient than government debt.

[4] Allen Consulting Group, op. cit., p. 86

In terms of employment generation, developer levies do more harm than good. When used to fund $5 billion worth of infrastructure over five years, developer levies actually result in a loss of over 3,100 jobs. Compared to using public debt financing, which creates close to 12,700. This is a net difference of some 16,000 jobs. [5]

Developer levies harm the economy because they are a tax on construction and ultimately housing. These levies target building activity, directly reducing jobs in this industry. Over time they reduce employment across the entire economy as the cost of paying for them is passed from developers onto consumers through higher house prices and rents putting pressure on wages to compensate.

Clearly, developer levies are an inefficient tax with undesirable effects. Concentrated on a narrow tax base, they result in reduced housing affordability and ultimately employment.

Any rational reading of the Allen Consulting Group's work leads to that the conclusion that developer levies are a flawed public policy instrument.

Superior financing options

The Allen Consulting Group findings pointed strongly to government debt instruments, such as bonds, as being the most efficient way to finance infrastructure.

In terms of GSP and employment, this mechanism generates vastly more gains than any other financing option. Government debt delivers at least $2 billion more GSP than its closet rival, PPPs and over 2,000 more jobs.

Compared to the worst performing financing mechanism, developer levies, using government debt to fund infrastructure delivers thirteen times the growth in GSP and creates 16,000 more jobs.

The economic impact of the various funding options is determined in the main by the way they affect the labour market.

The advantage of government borrowing is that it delivers infrastructure up font and spreads cost across time in line with the benefits that accrue as a result of the infrastructure. This 'fly now – pay later' factor means that the cost of investing in infrastructure is not only shared across the entire community, but also across generations. This intergenerational affect is extremely efficient and fair.

Given the very long life of infrastructure it makes sense for future users to contribute towards its construction.

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[5] Ibid, p.86

Because infrastructure is built today, employment receives an immediate stimulus through increased construction activity. Employment growth over time is then supported by the productivity growth brought about from the operation of new infrastructure (i.e. the growth dividend).

Of course, the debt has to be paid back. By spreading repayment costs over the long term, the impact on individuals is minimised because the tax base is so vast (it includes all taxpayers both today and into the future), and also as a result of the growth dividend offsetting tax increases.

Using developer levies to fund investment in infrastructure produces the opposite effects. This mechanism actually suppresses employment in the immediate term by adding to the cost of construction, hence deterring this activity.

In the longer term, developer levies drive up living costs because they make construction more expensive and so add to the cost of housing. Faced with higher living costs, through increased rents and house prices, people demand higher wages, which in turn leads to lower employment.

Market forces mean that developer levies are usually passed onto consumers through higher property prices.

As a result, using developer levies to fund infrastructure is adding to the housing affordability crisis already being experienced across Australia, particularly in Sydney.

Clearly governments need to reassess how they fund public urban infrastructure and change fiscal strategies to make far greater use debt instruments such as bonds.

The Allen Report on funding is annexed to this submission (Annexure B).

Barrier 4 — Statutory Instruments and Development Assessment

The link between development systems and the cost of assets has been made in several studies.

Glaeser and Gyourko (*The Impact of Zoning on Housing Affordability* 2002, Harvard University Press, Discussion Paper No. 1948) conclude:

"…if policy advocates are interested in reduced housing costs, then they would do well to start with zoning reform…reducing the implied zoning tax on new construction could have a massive impact on housing prices." Page 21

The Economist magazine made similar observations in its May 2003 edition.

Planning controls are separate to the issue of land supply programs.

They are germane to the *efficiency* of delivery rather than the *quantum* of land available for development.

A further related issue is the development assessment system itself.

In 1997, the government responded to recommendations prepared by an inquiry chaired by Charlie Bell. The report, *More Time for Business*, identified the need for reforms to the development assessment and building control processes. See recommendations 26 to 32 of the Bell report.

The current *Building for Growth Action Agenda*, which is occurring under the aegis of the Commonwealth Department of Industry, Science and Resources, further reinforced the need for comprehensive development assessment reform.

These recommendations supported recommendations made in several Property Council studies, notably *States of Progress*, *Planning for Change* and *Unfinished Business*.

The well documented cost of inefficient development assessment lead to the establishment of the Development Assessment Forum (DAF), which is discussed in greater detail later in this submission.

The point is that development delays add to the cost of development, including housing development.

It is important to distinguish two aspects of this inefficiency. The first relates to the processes utilised to make development assessment; basically, the decision-making tool kit used by industry and regulators.

The second relates to the decision-makers themselves – those who assess individual projects In short, the governance of the development assessment process.

The Property Council contends that governance processes at local government level are flawed. There is no clear separation between policy making (the rules of the system) and the assessment process (judgement).

This leads to uncertainty, delays, ad hoc policy making that is not aligned with overall strategic objectives and waste. These externalities create unnecessary development risks that ultimately translate into higher prices – for all accommodation users.

We recommend in the solutions section of this submission that the separation of powers doctrine should be applied to the local government level in order to remedy this failure.

Barrier 5: Low Income Earners and the Welfare Dependent

There is plenty of literature that indicates low income earners find it difficult to own or rent affordable housing. Some examples include:

- Affordable Housing National Research Consortium, Affordable Housing in Australia: Pressing Need, Effective Solution; September 2001
- Ballardin, A & Trudgett, S 2002, `Australia's housing affordability crisis: The policy choices' in Social investment in housing and urban development: Papers prepared for a round table organised by the Social Justice Project in conjunction with the Australian Housing and Urban Research Institute, eds R Richardson & J Disney, University of New South Wales, Sydney, pp.55-71.
- Berry, M & Hall, J 2001, Policy options for stimulating private sector investment in affordable housing across Australia: Stage 1 report: Outlining the need for action, Australian Housing and Urban Research Institute (AHURI), Melbourne.
- Brotherhood of St Laurence 1999, Housing Insecurity, Problems faced by low-income private tenants, Changing Pressures Bulletin No.7, Melbourne.
- Department of Family and Community Services (FACS) 2002, Australian Housing Statistical Update June 2002, viewed 15 January 2003, http://www.facs.gov.au/internet/facsinternet.nsf/aboutfacs/programs/house-austhousingmarket.htm
- Hudson, R 2002, 'Public rental housing: Investment and contemporary issues', Just Policy, no.25,pp.49-57.
- Hulse, K 2002. `Rent assistance: Time for a policy review?', Just Policy, no.25, pp.13-25.
- Monro, D 1997, Public rental policy: Learning the lessons from overseas, Research paper no.6 1997-98, viewed 15 January 2003, http://www.aph.gov.au/library/pubs/rp/index.htm.
- National Housing Strategy 1991, The affordability of Australian Housing, Issues Paper no.2, AGPS, Canberra.
- Perkins, M 2002, New public housing funding a pyrrhic victory', media release, National Shelter Inc., 25 October.
- Ridge, T 2002, ` Childhood poverty and social exclusion – listening to children', Poverty, no.113, pp. 11-13.
- Winter, I & Donald, O 2002, `Social investment in housing and urban development: An overview', in Social investment in housing and urban development: Papers prepared for a round table organised by the Social Justice Project in conjunction with the Australian Housing and Urban Research Institute, eds R Richardson & J Disney, University of New South Wales, Sydney pp.5-21.
- Wood, G A 2001, 'Promoting the supply of low income rental housing', Urban Policy and Research, vol 19. no.4, pp.425-40.
- Yates, J & Wulfe, M 2000, 'W(h)ither low cost private rental housing?' Urban Policy and Research, vol. 18, no.1, pp.45-64.

- Yates, J 2002a, A distributional analysis of the impact of direct and indirect housing assistance, AHURI, viewed 15 January 2003, http://www.ahuri,edu.au>
- Yates 2002b, 'The limits to choice in the private rental market', Just Policy, no.25, pp.32-48.

According to this literature, the needs of the welfare dependent and low income earners are more pressing than those of the broader community.

The solution lies in a major increase in stock.

Traditionally, this stock has been supplied by governments, generally under Commonwealth-State housing agreements.

The rising levels of housing stress identified by researchers provides evidence that this system has failed.

It may be argued that more public funds are required. However, a simple solution is to tap into the massive funds available in the capital markets. Innovative financing would help leveraged public funds to deliver a quantum leap in supply of stock for target groups in the community.

The Property Council recommends governments through the Council of Australian Governments examine opportunities for deploying such financing techniques.

At the same time, it should review the affordable housing assets on the public balance sheet, with their massive annual maintenance costs. Cost that obviously divert funds away from the capitalisation of new supply.

Finally, there is an argument for applying the subsidiarity principle to the management of government funded or assisted stock. This would mean shifting management away from the public sector to community groups.

These issues are explored in details in the recommendations section of this submission.

Chapter Six: Recommendations

There is no single solution to housing the affordability issue. The Property Council offers several recommendations for consideration under the following headings.

Planning-Based Solutions
Big picture planning
Urban and regional development framework
Housing framework
Land release programs
Statutory plans
Building regulation
Sustainability
Development assessment
Tax and Infrastructure Solutions
Indirect taxes
Developer charges
Infrastructure funding
Negative gearing
Targeted Solutions for Market Segments
Capital Markets Vehicles
First Home Owners Grant

Planning Issues

Recommendation 1: Big Picture: A National Approach to Planning

A fundamental thesis of this submission is that housing solutions for first home buyers will be more effective within the context of a broader planning framework.

The Property Council recommends The Council of Australian Governments resolve to develop a national strategic planning framework.

Such a framework would embody the following elements:

- it would establish urban, regional and rural development plans across the nation;
- such plans would adopt a thirty year horizon, with annual milestones;
- such plans would specifically aim to increase the nation's economic, social and environmental capital;

- the strategy would consolidate infrastructure funding programs across all government departments at spheres of government; and,
- each year specific infrastructure spending targets would appear as line items in federal, state and local government budgets.

The framework would be devised following a public inquiry. It would also specifically address housing issues, as we note in the following recommendation.

Such an inquiry would directly address matters such as Australia's net population growth, international competitiveness and evolving community aspirations.

A program, principles and terms of reference for such an inquiry are provided in Appendix 1.

Recommendation 2: National Housing Strategy

A key element of the overarching national strategy would be a program that specifically addresses short, medium and long term housing needs.

Mirror housing strategies would be prepared by all states and territories.

Such strategies would comprise the following elements:

- land release and management programs in line with overall urban growth strategies;
- forward zoning of all land to be released;
- programs for servicing land in tandem with land release schedules; and,
- the establishment of public land banking institutions with appropriate governance arrangements.

The Property Council proposes the integration of these activities by a single co-ordinating authority in each state and territory.

As a first step, an audit of surplus land should be conducted at all spheres of government.

Recommendation 3: Forecasts of Construction Activity

The Property Council recommends the Construction Forecasting Council be funded to forecast residential building activity in addition to its existing non residential building and engineering construction forecasts.

Such a service should:

- provide quarterly forecasts of activity over an initial two year horizon and annual forecasts for the subsequent eight years;
- disaggregate data to the major the regional areas of Australia; and,
- take the form of a public-private sector funded venture.

Since the scrapping of the Indicative Planning Council in 1997, there have been no reliable, readily available, low cost housing forecasts in the public domain.

The Construction Forecasting Committee, which is an initiative of the Australian Construction Industry Forum, currently provides forecasts for all infrastructure sectors bar residential development.

The provision of timely data on residential activity based on a rigorous methodology would provide considerable benefits to government, developers and those required to anticipate their needs for products and services.

Bottlenecks in materials, trades and skilled workers, clearly add to final consumption costs.

Recommendation 4: Statutory Planning Instruments

The Property Council recommends state, territory and local government commit to a new round of planning reform. This must encompass:

- creation of metropolitan strategies for our key cities incorporating medium term strategies for accommodating population growth and the provision of infrastructure needs (currently only Melbourne has a thorough medium term plan to guide its future growth);
- requirements for greater densities around existing transport nodes to deliver compact city outcomes and better utilise existing transport networks;
- a managed process of urban land release program to be incorporated operating within the umbrella of the metropolitan strategy;
- consolidation of legislation dealing with land use into one piece of legislation to remove inconsistencies and provide greater clarity;

- reform of legislation governing plan making to reduce complexity and provide greater strategic input to statutory planning instruments;
- reform of legislation and practices governing development assessment to ensure more efficient decision making;
- maximise use of web-based planning platforms to provide greater accessibility to environmental planning instruments and online DA lodgment; and,
- adopt simplified evidence-based sustainability controls such as the NSW BASIX sustainability planning tool.

Recommendation 5: Development Assessment

The Property Council recommends that all governments commit to the development assessment reform program to be proposed by the Development Assessment Forum in early 2004.

In doing so, the Property Council calls on governments to cut red tape and deliver a dividend in jobs, greater investment, a more efficient market and a quality built environment.

It is further recommended that in doing so they commit to a reform timetable that will see the harmonisation of best practice development assessment systems by 2006 at the latest.

There are already several reviews under way in Victoria, NSW and Western Australia.

A summary of the general thinking of the DAF program is contained in Appendix 2.

As a member of DAF, the Property Council proposes the following key policy principles be adopted by all jurisdictions:

Separation of powers – the task of developing the policy that drives planning codes (based on community values and strategic goals) should be separated from the task of assessing development proposals against such codes.

In other words, the role of councils (acting as a parliament) should be separated from the role of assessors (acting as a judiciary).

Technically excellent policy criteria based on community engagement – the community values and strategies set by governments should be codified as objective tests and rules.

A single assessment authority – state and territory governments should establish a single assessment authority to consider any project application. Such an approach will end the round robin of referral and concurrence. Relevant government (concurrence) agencies should only implement their assessment criteria through the single assessment authority, after they have formulated technically excellent policy criteria.

Expert assessment bodies at state/territory and local levels – each level of government should appoint an independent assessor, whether one person or a panel. Relevant state/territory government ministers should retain call in powers. If constituted as a panel, the assessment body should contain expert representatives from relevant stakeholder groups. Serving councillors should not comprise more than one third of any such panel.

Private certification – private certification of the basic tasks of the assessment process (validating conformance with planning codes) should be encouraged.

Appeals as a second expert assessment – appeals should be forwarded up the ladder to a specialised appeal authority and judged against the technically excellent policy criteria.

Third party appeals – no third party appeals given that under the proposed system a development assessment is to be made against technical criteria that enshrines policy developed after community consultation. If a stakeholder disagrees with an outcome, they will need to democratically advocate change the policy criteria.

Streaming of development assessment into tracks – early in the process, a project application should be streamed into a specific assessment track based on the complexity of the project.

Each track will comprise a specific set of logical decision making steps relevant to the potential impact of the project on the built environment. Some projects will be exempt or self assessed, while others will require major examination. The aim is to agree on a development assessment logic that will reduce wasteful compliance costs and delays, while at the same time meeting community needs.

These reforms will reduce a large portion of the unnecessary housing costs that arise from regulatory inefficiency.

Recommendation 6: Sustainability

Another area where the evolution of ad hoc public policy threatens to increase housing costs falls under the broad heading of `sustainability'.

As previously noted, sustainability policy should be integrated into overall strategic planning policy.

In addition, sustainability policy should cover the following issues:

- energy/greenhouse;
- water;
- waste; and,
- air quality.

The Property Council recommends sustainability codes and rating tools should be harmonised across the country under a single brand name to reduce market confusion.

The Australian Building Codes Board should be charged with preparing changes to the Building Code of Australia that eliminate poor sustainability practices in relation to the residential sector.

The Property Council further recommends that governments offer financial incentives for early adoption of sustainability measures.

Such incentives should take the form of accelerated amortisation rates for investment dwellings, along with accelerated depreciation for plant and equipment that meet higher sustainability criteria.

Such criteria to be developed in consultation with industry.

Other incentives, such as higher development bonuses should also be explored.

Recommendation 7: Building Code of Australia

In addition to sustainability issues, there are other failures of policy in relation to building regulation that drive up housing costs.

Chief amongst these is the absence of a National Administrative Framework for applying the BCA.

Governments should commit to developing such a framework as a high priority.

The finalisation of a national plumping code is another matter that would reduce the cost of building dwellings.

Recommendation 8: Harmonised Legislation

Complying with Australia's unnecessarily diverse federal regulatory regime costs money. That cost is added to house prices.

In March this year, the Productivity Commission's chair referred to this issue in a paper called "Reducing the Business Cost of Regulation".

A new approach is required for building codes, occupational health and safety, workers compensation schemes, conveyancing, in fact, all aspects of construction and real property law.

There are several models of policy making and regulation that harmonise the rules of the system in Australia. For instance, ASIC, APRA and Food Standards operate under Commonwealth law backed by mirror state/territory legislation.

A similar approach is required in the construction real estate sectors.

Taxation

Recommendation 9: Developer Charges

Developer charges should online be applied in line with the following principles:

- need must be established and supported by a Contribution Impact Statement;
- there needs to a nexus between the charges and the public good they are designed to help fund;
- developer charges should be restricted to water supply, sewerage, storm water, electricity, local roads - they should not fund broader social infrastructure given the equity and efficiency grounds already discussed;
- they should align an implementation program for contributions and a fiscal strategy to enable efficient, economic and equitable administration;
- such programs should form part of an overall infrastructure strategy that council's must submit to the relevant state planning or local government department;
- contributions in the form of developer charges be held in a trust fund that is subject to transparent governance; and,
- developer contributions be calculated using a totally transparent methodology and that developers have the right to request an audit of calculations.

Utilities that wish to charge for contributions should be subject to the same arrangements.

Recommendation 10: Other Infrastructure Funding Taxes

Other proposed new taxes and levies for funding infrastructure should be rejected.

New taxes and levies currently being debated within state and territory governments include:

- flat developer levies,
- extension of local council developer contribution schemes to also raise funds for state-level infrastructure,
- asset value capture levies,
- additional across-the-board transport improvement rate levies,
- new levies on employers who locate in transport nodes, and
- parking levies.

As the Allen Consulting Group report shows, these are some of the most inefficient funding mechanisms open to governments.

Recommendation 11: Rate Pegging

The Property Council recommends the Council of Australian Governments conduct an inquiry into rate pegging.

Rate pegging limits a council's ability to tax constituents using the equity features inherent in the rating system. Instead, they turn to non transparent and inefficient taxes, such as develop charges.

As the Allen Consulting Report shows, these charges are often counterproductive and inevitably increase the cost of housing.

Recommendation 12: Infrastructure Funding

The Property Council recommends that governments adopt the findings of the Allen Consulting Group report, *Funding Urban Public Infrastructure*.

It is recommended this matter be explored by the Council of Australian Governments. Some of the key issues to be canvassed include:

- the creation of government borrowing budgets for states and territories;
- the revision of Loans Council methodologies to accommodate higher government borrowings;
- finalisation of effective reforms to Division 250 of the 1997 Income Assessment Act; and,
- methodologies for allocating borrowed funds to state/territory government departments and local councils.

In addition, the Property Council contends that governments should take greater advantage of special funding vehicles, such as public-private partnerships.

Recommendation 13: Stamp Duty

The Property Council recommends that all Australian governments agree to move forward the timetable for the reviewing of taxes under the *Intergovernmental Agreement on the Reform of Federal-State Financial Arrangement*.

Clause 5 (vii) of this agreement states that the parties will conduct a review of a range of inefficient taxes by 2005.

Stamp Duty on residential conveyances is not included in this review.

The Property Council, as a member of the Business Coalition for Tax Review, proposes that opportunities for phasing out taxes such as residential stamp duty be explored by such a review, which should:

- develop a methodology and timetable for phasing out inefficient business taxes noted in the original Intergovernmental Agreement;
- suggest options for eliminating other inefficient taxes as part of an overall indirect tax reform program, once business taxes have been reformed.

As an interim step, the cascading impact of taxes on taxes, such as stamp duty charged on the GST inflated price of asset sales, should cease.

A draft Terms of Reference for such a review is contained in Appendix 3.

Recommendation 14: Negative Gearing

The Property Council recommends the Federal Government re-affirm the importance of negative gearing.

The introduction of restrictions on negative gearing would be inequitable in terms of both horizontal and vertical equity, as they would disproportionately impact the average investor, rather than high-wealth individuals. This is because high-wealth individuals have a greater capacity to adjust the matching of their assets and liabilities to avoid any restrictions, due to the greater quantum and range of their assets.

Any restrictions on negative gearing would also create further tax-induced inefficiencies among the investments held by investors, and would be almost impossible to implement in a simple and cost effective manner. In particular, any attempt to limit the negative gearing of property investments would add to the substantial existing tax-induced distortions currently inhibiting further investment in the property sector.

There are several fundamental reasons why it is imperative that negative gearing continue to be available for investments in Australia.

- First, the availability of negative gearing is essential to create the appropriate conditions and incentives for further investment in Australia. Related to this is the fact that a substantial amount of any incentive associated with negative gearing is already capitalised in the price of the relevant assets. This means that any tightening up in this area will lead to capital losses to existing asset holders, a reduction in supply and little if any gain in taxation revenue;
- Secondly, and perhaps most importantly, the fundability of money means that it is frequently difficult to ascribe the cost of borrowing to investments, so that any quarantining mechanism will be inherently arbitrary; and
- Thirdly, any attempt to limit the availability of negative gearing for investments would create further inefficiencies and inequities in the taxation of investments.

Negative gearing is also critical to motivating institutions to create vehicles for capitalising the supply of targeted affordable housing stock, as we show in the following recommendations.

Targeted Affordable Housing Measures

In addition, to systemic policy reforms that will lower the overall cost of housing, the Property Council proposes several initiatives designed specifically to assist low income earners.

The aim of these recommendations is to increase the *supply* of quality housing to those categorised as the `working poor'.
It is unlikely the private sector will enter this market without government assistance, due to low investment returns.

At present government bears virtually all the costs of providing this targeted housing. It does not leverage the value of each taxpayer dollar allocated to housing construction (and management). It spends a dollar and (hopefully) receives a dollar of value.

However, there is a massive volume of private capital that could be applied to remedy the shortage of housing stock. A large portion of this lies with institutional investors, who currently hold $700 billion in investments.

The allocation of funds to affordable housing vehicles may also attract to those seeking Socially Responsible Investments (SRI).

However, incentives are required to justify greater private investment. Such incentives can be found by increasing public expenditure, re-allocating existing funds under arrangements such as the Commonwealth-State Housing Agreement (CSHA) or foregoing tax revenue through the use of tax incentives.

The Property Council proposes the government employ a mixture of these devices in order to encourage the capital markets to **create a new asset class of affordable housing vehicles**.

These vehicles can take the form of bond like instruments or listed affordable housing securities, which are explained below.

In short this involves discounting the market price of homes to users by way of a public subsidy, the value of which is leveraged by private financing mechanisms.

Recommendation 15: Coordinate Innovative Financing Solutions with Innovative Management

The Property Council recommends government establish a body to oversee the introduction of innovative financing techniques in Australia. Such body would also work with community groups to redirect management of affordable housing stock away from government department.

The Property Council proposes the US Fannie Mae affordable housing and community development model serve as a starting point for discussion.

Recommendation 16: Planning for Affordability

Given that increasing the supply of targeted affordable housing will involve a public-private partnership it needs to be planned.

Greater strategic planning is a leitmotiv of this submission. The market failure in targeted affordable housing reinforces our point on the virtues of this activity.

In the Property Council’s view, the supply and distribution of affordable homes should form an integral component of the hierarchy of strategic plans proposed in other recommendations.

There is plenty of evidence that NIMBYISM also constrains the development of social housing, child care, aged car and affordable housing facilities. Consequently, it is crucial that planning controls and the development assessment system encourage appropriate development. This point further reinforces the Property council's previous recommendations in relation to planning and development assessment.

Recommendation 17: Reject Inclusionary Zoning

So called, `inclusionary zoning' forces developers to allocate a certain portion of new development to qualifying low income earners.

The Property Council recommends the rejection of this policy on the following grounds:

- It is a piecemeal solution that delivers a trivial number of dwellings to the market place compared to the preferred approaches outlined in this submission;
- It merely adds to the cost of development, while inefficiently and inequitably defraying those costs to home buyers or renters. The analogy with developer charges is clear.

Recommendation 18: Conduct Pilot Study Using Innovative Financing Vehicles

The Property Council recommends COAG commit to an intergovernmental pilot study that tests the efficacy of private financing vehicles.

Two studies are proposed:

The first using the bond vehicles proposed by the Affordable Housing Consortium, of which the Property Council is a member.

The Consortium has made a submission to the inquiry.

The second, would involve the establishment of a listed affordable housing vehicle.

The details of this vehicle are contained in Appendix 5. An outline is provided below.

Recommendation 19: Listed Affordable Housing Trust (LAHT)

The Property Council's securitised affordable housing trust model attempts to achieve the following goals:

- deliver a sizeable increase in the supply of good quality new accommodation that meets affordability criteria;
- attract private sector funds by offering stable and attractive returns;
- deliver accommodation to tenants at affordable rates;
- provide tenants with an opportunity to purchase their homes, thereby giving them equity in their homes instead of paying dead rent money. Such an approach also raises capital that can be devoted to capitalising more affordable housing stock;
- reduce the massive maintenance costs associated with affordable housing by giving people to look after the premises they can one day own;
- leverage the value of every dollar of public money spent – in the example used in the case study contained in Appendix 5, it can translate a $30 million public contribution into an $840 million pool of affordable housing assets;
- remove the distinction between lower quality housing for the poor and better quality premises for the rest of the community; and,
- divert a portion of funds from the inefficient construction of affordable housing to a vehicle that can deliver `more bang for the public buck' by using rent subsidies to attract private sector capital - in the LAHT model described in the appendix, every $1 of taxpayers money converts to $28 that can be spent on affordable accommodation for target groups.

Full details of the model appear in Appendix 5.

Recommendation 20: Remove Affordable Housing from the Public Balance Sheet

The Property Council proposes all governments should audit the affordable housing stock they own. They should then assess which assets can be privatised.

Recommendation 21: Community Housing Groups

The Property Council proposes that community housing groups take over the management of the bulk of targeted affordable housing.

The Property Council recommends government:

- agree to a substantial role for community housing in developing and delivering housing outcomes, integrated with other social and economic outcomes;
- agree to a risk sharing arrangement with the community housing sector;
- provide additional capital funds and rental/operational subsidies for substantial growth;
- assist the sector to unlock substantial levels or private finance through efficient and effective avenues;
- agree to a nationally consistent system of regulation and accountability;
- agree to the transfer of housing assets and equity to the sector within a risk management and regulatory framework;
- support the National Standards and Accreditation system and the ongoing development of good practice;
- agree to resourcing capacity building and infrastructure support; and,
- strengthen a national strategy for data collection, research and development.

Conclusion

Affordable housing issues are divided into several categories. A suite of solutions are required for each group.

Nevertheless, many of the factors driving house prices to unaffordable levels are common to all categories. These factors arise due to failures of public policy.

This submission by the Property Council outlines comprehensive solutions to these problems, the bulk of which relate to planning, taxation and infrastructure issue.

The Property Council is happy to expand upon on any of the matters raised in this submission.

Appendix 1:

Action Plan for Achieving a National Planning Strategy

Recommendation One: ***Agree Action Framework***

Adopt a seven step strategy for achieving an urban policy in Australia:

1. Take responsibility and agree a vision
2. Establish direction
3. Establish guiding principles
4. Develop new roles, activities and institutions
5. Encourage change
6. Assess performance
7. Review and revise

Recommendation Two: ***Call to Action***

Call on the Prime Minister, Premiers and Chief Ministers to appoint a leading figure to conduct an inquiry into urban Australia that will report directly to the Council of Australian Governments.

Recommendation Three: ***Agree Guiding Principles for a New Urban Partnership***

Adopt the following set of principles to promote consistency and coherence in the shaping of a national urban strategy:

- *Subsidiarity* — provides for decision making at the lowest appropriate level.
- *Integration* — Many of the characteristic problems of urban areas are multidimensional and can be traced to a lack of integration amongst public sector activities, between different levels of government and between various policy sectors. Basically this principle requires a genuine whole of government perspective.
- *Partnership* — this is needed because complex urban problems cannot be solved by single government bodies or agencies alone. It is important to involve citizens, the private sector and community interests at the local level if aspirations are to be crystallised and realised.
- *Environmental sustainability* — involves a precautionary approach and the efficient use of natural resources and minimising waste and pollution. Actions and policies have to be reconciled with their implications for environmental systems. Actions and policies should look to enhancing or preserving environmental assets. Managing urban areas should also take into account the context of the wider bio-region.
- *Equity* — actions and policies taken in cities must be designed to promote equity and equal opportunity. Arrangements have to be fair.

- *Economic efficiency* — reflects a wish to strengthen the economic potential of urban areas. This principle also recognises that intervention is sometimes required because of market failures.
- *Spatial implications* — because the spatial dimension has been underplayed for so long in Australia it is important there is a specific principle for it when framing an Australian approach. This would oblige the consideration of actions and policies to take account of the specific urban context. This would be helpful in ensuring that strategy development did not fall into the trap of attempting to merely make standard policies 'urban' friendly.
- *Accountability* — there needs to be accountability on at least two levels: for the process, which has to be open, transparent, fair and consistent with high standards of probity; and for the outcomes of actions, which have to be efficiently and effectively delivered. It is insufficient to merely hold decision makers accountable for inputs, which was a traditional model of accountability.

Recommendation Four: Suggested Model for an Urban Partnership

In the past, Australia's more ambitious intergovernmental approaches tended to take a top down approach. For instance, competition policy. The Property Council proposes a top down, bottom up approach.

The most recent example is the National Action Plan (NAP) to combat salinity and land degradation in rural Australia.

"(NAP) involves a mixing of visions and principles heading in a downward direction resulting from Commonwealth and state government negotiations and agreements, with action plans and blue prints prepared at the local level heading up (for accreditation and funding, …)" [6]

A comparison of the two potential approaches is highlighted in the following case study.

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[6] *Page 62 Recapitalising Australia's Cities (The Allen Consulting Group).*

National Competition Policy In 1995 Australian governments in CoAG reached three agreements establishing the national Competition Policy (NCP). These were: Competition Principles Agreement, the Agreement to implement the National Competition Policy and Related reforms, and the Conduct Code Agreement. Implementation of the NCP, including a detailed review of legislation and the development of legislative changes, in each jurisdiction was the responsibility of relevant Governments. In the case of the States, the overarching principles and objectives of NCP were also translated into reforms at the local government level. To facilitate (and enforce) State implementation of NCP, the Commonwealth made available significant sums of money in the form of Competition Payments, which were provided to States and Territories on the condition that NCP and other CoAG-endorsed national reforms (e.g., water resource policy) were implemented. New intergovernmental institutions – for example, the National Competition Council (NCC) – were established to facilitate the implementation of NCP. In particular, the NCC reviews State and Territory progress in implementing NCP and other reforms and makes recommendations to the Commonwealth Treasurer on whether States should have all or part of the Competition Payments withheld due to lack of progress with implementation. Following the five year review of the NCP all governments affirmed the importance of the NCP in sustaining the competitiveness and flexibility of the Australian economy and contributing to higher standards of living. They recommitted to the NCP for a further five years.
Source: National Competition Council, 2001, Annual Report: 2000-2001, AusInfo, Canberra

National Action Plan Funding for the National Action Plan (NAP) totals $1.4 billion over seven years made up of $700 million in new expenditure by the Commonwealth with an equivalent amount of matching funding from the States and Territories. The NAP will involve six elements, all of which are necessary to achieve lasting improvements over dry land salinity and deteriorating water quality: • targets and standards for salinity, water quality and associated water flows, and stream and terrestrial biodiversity agreed either bilaterally or multilaterally; • integrated catchment/regional management plans, developed by the community and accredited jointly by Governments, in the 21 priority catchments/regions that are highly affected by salinity, particularly dry land salinity, and deteriorating water quality; • capacity building for communities and landholders to assist them to develop and implement integrated catchment/region plans, together with the provision of technical and scientific support and engineering innovations; • an improved governance framework to secure Commonwealth-State/Territory investments and community action in the long term: including property rights; pricing; and regulatory reforms of water and land use; • clearly articulated roles for the Commonwealth, State/Territory, local government and community to provide an effective, integrated and coherent framework to deliver and monitor implementation of the NAP, and, • a public communication program to support widespread understanding of all aspects of the NAP so as to promote behavioural change and community support.
Source: COAG (Council of Australian Governments), Council of Australian Governments Communiqué, Media Release from the Prime Minister, Canberra, November, 2000

Recommendation Five: Adopt National Inquiry – Terms of Reference

The Property Council recommends adoption of the attached terms of reference for the proposed inquiry. See Appendix A.

A NATIONAL COMMISSION OF INQUIRY INTO AUSTRALIA'S CITIES

DRAFT TERMS OF REFERENCE

Background and Mission

Three things are needed to establish an appropriate direction for an Australian urban strategy:

- establish the current situation and outlook;
- identify a more favourable position; and
- consider how to achieve progress towards the favourable position.

Experts in urban policy may consider that they know what is needed already, but there is a need to bring along the remainder of the policy community and, indeed, the community in general.

There is a proven approach in Australia to the formulation of strategic direction. It is the inquiry. This is normally chaired by a leading figure in the community. Examples in the field of economic policy include the Hilmer report about implementation of National Competition Policy, The Wallis Financial System Inquiry report, and the National Commission of Audit report chaired by Bob Officer. Each of these reports instigated a process that led to substantial change.

Inquiry Elements

The inquiry will be commissioned by the Council of Australian governments (COAG)

The elements of an inquiry in this context include:

- an Inquiry team comprising people with standing in the areas related to economic, social, environmental and governance capital who have an appreciation of the significance of the spatial dimensions of these forms of capital;
- chaired by an eminent person able to lead debate across all stakeholders;
- inclusive processes, probably through national consultation;
- a non prescriptive terms of reference;
- provision of adequate resources and time to produce a credible result; and
- agreement by all governments to the Inquiry members and processes.

TERMS OF REFERENCE

1.0 Situation Analysis: The Need For Change

1.1 The Inquiry will initially assess the situation for each of Australia's urban locales in relation to at least four interconnected types of capital including:

- *economic prosperity and competitiveness* — reviewing the global competitive strengths of Australia's cities, looking beyond endowments of land, labour and capital to their capacity for innovation and growth, looking also at potential for complementary roles between cities;
- *social inclusion and exclusion* — to assess the equity of participation in the social and economic life of the community and access to the benefits of economic growth and opportunity. This will involve a stock take of the social capital in cities and provide an overarching assessment about the level of connectedness with place and community;
- *environment and sustainability* — to evaluate if and where current development approaches in our cities and urban areas is imposing avoidable and unsustainable damage on the environment; and
- *local empowerment and governance*— to assess if and where approaches to decision making processes about government actions impact upon participation and legitimacy. The challenge is to identify the scope for more innovative and flexible decision making processes and urban institutions that will extend participation and integrate the actions of partners in urban public, private and community sectors.

1.2 In undertaking this assessment the Inquiry will examine the impact of existing government policies on these attributes, and examine the interconnectivities between policies and outcomes at a broad level.

1.3 The Inquiry will contribute towards the establishment of baseline data against which future progress should be measured.

2.0 A Framework for Change

2.1 The proposed Inquiry will recognize that building good governance implies that the means are as important as the ends, and as such will also set out a plan for achieving change.

2.2 The Inquiry will identify what governments and governance institutions should actually do. To be effective and shape outcomes, a national urban strategy needs to link a national strategy for cities with specific city strategies and ultimately to spatial policy reviews and major actions in cities along with their implications for regional and rural Australia.

2.3 The Inquiry will make recommendations on intergovernmental reforms and structures needed for full implementation.

2.4 The inquiry will provide guidance and direction to linking fiscal arrangements to any reforms needed or subsequently required for implementation of the findings

3.0 A Top Down/Bottom Up Plan

The Inquiry will have regard to subsidiarity principles and as such the identification of how to get where will involve top down and bottom up approaches.

4.0 A Public Inquiry in the National Interest

In conducting its investigations the Inquiry will invite submissions and seek information from any persons or bodies.

5.0 An Inquiry for Action and Direction

The Inquiry is established to set a framework for change and action. Its directions will lead to further reform by others.

It will set out desired actions by all stakeholders.

Timeliness of reporting is imperative with a report to be complete within 12 months of commission.

Appendix 2:

Development Assessment Forum Program

(To be provided independently by DAF)

Appendix 3:

Proposed Draft Terms of Reference Review of Inefficient Indirect Taxes

(Prepared by The Business Coalition for Tax Reform)

Review of the Scope to Eliminate the Remaining IGA Taxes.

Draft Terms of Reference

Preamble

1. Among the taxes levied by State and Territory governments are some of the most inefficient taxes in Australia.
2. A major objective of the New Tax System (ANTS) was to improve the systems of indirect taxation at federal, state and territory levels.
3. This objective was explicitly stated in the revised Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations of June 1999 (IGA).

"The objectives of the reforms set down in this agreement include … the elimination of a number of existing inefficient taxes which are impeding economic activity."

The relevant taxes were listed in Appendix A to the IGA. This Appendix is reproduced at Attachment A to this Terms of Reference.

4. Among the taxes the IGA has as its objective to eliminate are a number of taxes still in place in some or all States and Territories. These are Debits tax; stamp duty on non-residential conveyances, leases, mortgages, debentures, bonds and other loan securities, credit arrangements, instalment purchase arrangements and rental arrangements, and on cheques, bills of exchange, promissory notes; and unquoted marketable securities ("the remaining IGA taxes").
5. Under the terms of the IGA it was agreed that the scope to remove these taxes would be the subject of a review to be completed by 2005.

Objectives of the Review

6. This review will examine the remaining IGA taxes, will establish and make available a methodology for examining the financial scope of the States and Territories to eliminate these taxes and will make recommendations concerning their removal.

    6.1 In examining the feasibility to remove these taxes, the Review will consider, in particular, the impact of these taxes on economic activity, the inefficiency of these taxes, the costs of their administration and the compliance costs they impose on taxpayers.

6.2 In establishing the methodology for examining the scope for the removal of these taxes, the Review will examine, *inter alia*, the amount of revenue raised by the remaining IGA taxes in the various States and Territories and the current projections of GST revenues flowing to the different States and Territories - in both cases relative to revenue projections available in June 1999 before the introduction of the GST when the States and Territories agreed to the terms of the IGA.

6.3 In making recommendations for the removal of the remaining IGA taxes, the Review will be mindful that the leading objective of the IGA was the elimination of the remaining IGA taxes.

6.4 The Review will make recommendations concerning:

- the immediate capacities of the different States and Territories to remove some or all of the remaining IGA taxes; and
- the projected capacities of the various States and Territories to remove remaining IGA taxes over following years
- the measurement of the capacities of the States and Territories to remove the remaining IGA taxes.

6.5 In the case of the projected capacities to remove the remaining IGA taxes, the Review will establish clear benchmarks to indicate when the various States and Territories are expected to have the capacity to remove remaining IGA taxes.

7. The Review will also identify other inefficient indirect taxes levied by the States and Territories and the scope for their removal.

The Process of the Review

8. The Review will be chaired by a qualified person independent of any of the parties to the IGA or their agencies.

9. The Commonwealth Department of the Treasury will provide the Secretariat.

10. The Review will consult widely with and call for submissions from interested parties.

11. The Review will publish submissions including those of the Commonwealth, State and Territory governments.

12. The Review's will report to the Ministerial Council by …….

13. The Review's report will be made public within one month of reporting to the Ministerial Council.

Attachment A

This attachment reproduces in full appendix a of the revised intergovernmental agreement of june 1999.

Taxes Subject to Reform

The taxes which will cease to apply in accordance with paragraph 5 of this Agreement are set out below and in the relevant Commonwealth, State and Territory statutes as at 13 November 1998.

A1. The following taxes will cease to apply from 1 July 2000:

(i) Wholesale Sales Tax
Sales tax levied on the value of the last wholesale sale of goods sold or otherwise dealt with as imposed by the Commonwealth's *Sales Tax (Imposition) Acts*.

(ii) Bed Taxes
Accommodation taxes levied on the cost of temporary residential accommodation.

A2. The following State and Territory taxes will cease to apply from 1 July 2001:

(i) Financial Institutions Duty
Financial Institutions Duty levied on the value of receipts (credits) at financial institutions and on the average daily liabilities and/or investments of short term money market dealers.

(ii) Stamp Duty on Marketable Securities
Stamp duty levied on turnover (ie sale price times quantity traded) on the transfer of marketable securities quoted on the ASX or another recognised stock exchange.

This excludes transfers of marketable securities in private companies and trusts, and in public companies and trusts where the securities are not quoted on the ASX or another recognised stock exchange.

A3. The following State and Territory tax will cease to apply by 1 July 2005, subject to review by the Ministerial Council:

(i) Debits Tax
Debits tax levied on the value of withdrawals (debits) from accounts with financial institutions with cheque drawing facilities.

Debits duty levied on transactions, including credit card transactions. This does not include stamp duty on electronic debits (refer A4 (v) below).

A4. The Ministerial Council will by 2005 review the need for retention of stamp duties on the following:

(i) Stamp Duty on Non-residential Conveyances

Stamp duty levied on the value of conveyances other than residential property conveyances.

(ii) Stamp Duty on Non-quotable Marketable Securities

Stamp duty levied on transfers of marketable securities in private companies and trusts, and in public companies and trusts where the securities are not quoted on the ASX or another recognised stock exchange.

(iii) Stamp Duty on Leases

Stamp duty levied on the rental payable under tenancy agreements.

(IV) Stamp Duty On Mortgages, Bonds, Debentures And Other Loan Securities

Stamp duty levied on the value of a secured loan property.

(v) Stamp Duty on Credit Arrangements, Instalment Purchase Arrangements and Rental Arrangements

Stamp duty levied on the value of the loan under credit arrangements.

Stamp duty levied on credit business in respect of loans made, discount transactions and credit arrangements. Stamp duty levied on the price of goods purchased under instalment purchase arrangements.

Stamp duty levied on the rent paid in respect of the hire of goods, including consumer and producer goods.

(vi) Stamp Duty on Cheques, Bills of Exchange and Promissory Notes

Stamp duty levied on cheques, bills of exchange, promissory notes, or other types of payment orders, promises to pay or acknowledgment of debts, including duty on electronic debits.

Appendix 4:

The Case for Negative Gearing

Property Council of Australia
Report on the Arguments for the Retention of Negative Gearing
October 1999

Introduction

The introduction of restrictions on negative gearing would be inequitable in terms of both horizontal and vertical equity, as they would disproportionately impact the average investor, rather than high-wealth individuals. This is because high-wealth individuals have a greater capacity to adjust the matching of their assets and liabilities to avoid the restrictions, due to the greater quantum and range of their assets.

Any restrictions on negative gearing would also create further tax-induced inefficiencies among the investments held by investors, and they will be almost impossible to implement in a simple and cost effective manner. In particular, any attempt to limit the negative gearing of property investments would add to the substantial existing tax-induced distortions currently inhibiting further investment in the property sector.

In this context, this report examines the arguments for the retention of negative gearing of investments.

1. Background

2.1 The Deductibility of Interest

A number of groups have already suggested that restrictions be introduced to quarantine the deductibility of interest for negatively geared investments in property and shares to the income or capital gains from those classes of investments.

Such restrictions on negative gearing would be inequitable in terms of both horizontal and vertical equity, they would create further tax-induced inefficiencies among the investments held by investors, and they will be almost impossible to implement in a simple and cost effective manner. In this context, this report examines the arguments for the retention of negative gearing of investments.

2.2 What is Negative Gearing?

An investment is said to be negatively geared where the current income derived from the investment exceeds the interest incurred to finance the investment, as well as the other deductible expenditures associated with the investment.

The most common example of negative gearing is the purchase of a rental property by an investor. The purchase is structured so that the loan repayments exceed the rental income in the early years of the investment. Accordingly, the taxpayer would not be taxed on the rental income. In addition, the resulting loss (i.e. the excess rental property loan interest) can be claimed by the taxpayer as a deduction against the taxpayer's assessable income from other sources, such as salary and wages or interest income. In this way, the taxpayer reduces his or her overall effective tax rate and may make a capital gain on the eventual sale of the property.

2.3 History of Negative Gearing in Australia

During the 1985/86 and 1986/87 tax years, the Hawke Labor Government restricted the availability of negative gearing by limiting the deduction for interest costs on money borrowed to purchase rental property in any year to the rental income in that year after deducting expenses other than interest.

Non-interest expenses, such as repairs remained deductible against other income in so far as they exceeded gross rental income. Any excess interest could be carried forward to be deductible against future rental income from the property.

These restrictions on the negative gearing of rental property were introduced to address supposed efficiency and equity concerns arising from negative gearing.

The efficiency concern is that negative gearing might distort relative asset prices and the allocation of resources by creating biases in favour of particular investments that yield a higher proportion of capital gain rather than income, such as rental property. Accordingly, it is argued that some investors may purchase assets that are relatively inefficient on a before-tax basis in order to receive relatively efficient after-tax returns.

The equity concern is that negative gearing benefits high-wealth individuals, with the capacity to invest in rental property, shares and other investments, who can use the provisions to shelter their taxable income, at the expense of lower income taxpayers

However, in actual fact, the restrictions imposed on the negative gearing of rental property between 1985 and 1987 had an adverse effect on investment in rental property by investors and hence on the stock of rental housing during this period. Serious shortages of rental properties developed during this period, at least partly resulting from the restrictions on negative gearing, and rents increased substantially. This is reflected in the sharp decline in the number of building approvals and building commencements during the 1985-86 and 1986-87 years.

Private sector residential building approvals declined by 11% in 1985-86 and a further 12.5% in 1986-87. Similarly, residential building commencements declined by 10.4% in 1985-86 and a further 14.1% in 1986-87.[7]

The significant impact of the quarantining of negative gearing of rental property on the housing market was recognised by the Commonwealth Treasury, in its Treasury Research Paper, *Asset Price Inflation*.[8] In that paper, it was noted that the introduction of the quarantining of negative gearing served to increase the after-tax cost of finance for heavily geared investors, reducing the after-tax rate of return on investment property.

It was further noted that:

"the above changes could be expected to result in a lower level of investment in residential property and in time lower levels of vacant dwellings - so placing upward pressure on rental yields. It appears this adjustment process was well in train by mid-1987, at least in the Sydney property market. The size of the adjustment that took place was partly attributable to the fact that quarantining only occurred in the property sector, leading to an outflow of funds from this sector to take advantage of the continued availability of deductions for other negatively geared investments."

Further, there is no evidence to suggest that these restrictions improved the equity, efficiency or simplicity of the tax system. In fact, the legislative restrictions were widely perceived to be overly complex, vague and onerous. It is also reasonable to assume that the sharp increase in rents at that time impacted unevenly on lower income individuals and families.

This was reflected in the subsequent removal of the restrictions, after only a relatively short period of time, in the 1987 Federal Budget. In this regard, it is noteworthy that the rental property market recovered significantly in 1987-1989, soon after these restrictions were removed. This is reflected in the sharp increase in the number of building approvals and building commencements during the 1987-88 and 1988-89 years.

Private sector residential building approvals increased by 27.9% in 1987-88 and a further 18.2% in 1988-89. Similarly, residential building commencements increased by 19.2% in 1987-88 and a further 28.1% in 1988-89.[9]

However, the scope of negative gearing is currently limited to a certain extent by the Full High Court decision in *Fletcher & Ors v Federal Commissioner of Taxation* (1991) 91 ATC 4950. In that case, the Court pronounced three legal principles that are relevant to the negatively geared investor.

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[7] Source: Australian Bureau of Statistics, *Australian Economic Indicators*, November 1992, ABS Catalogue No. 1350.0, Table 6.6 and Table 6.7.
[8] The Commonwealth Treasury, "Asset Price Inflation" by Tony Urbanski, Principal Advisor's Unit, Treasury Research Paper No.1, December 1990.
[9] Australian Bureau of Statistics, ibid.

First, where an investment is negatively geared, the question as to the deductibility of an outgoing must be answered by reference to the subjective purpose for which the outgoing was incurred.

Secondly, the negatively geared investment must be aimed at producing assessable income. This nexus, in some circumstances, may be satisfied by the hope that the capital gain on eventual disposal of the asset will exceed the losses incurred due to the negative gearing.

Finally, where the subjective purpose of a negatively geared investor in respect of the loss arising from the investment has no connection with the production of assessable income, the Court will limit the available deduction to the assessable income actually derived as a result of the outgoing.

In the following section of this report we have outlined the reasons why the negative gearing of investments should continue to be permitted.

3. Arguments for the Retention of Negative Gearing

There are several fundamental reasons why it is imperative that negative gearing continue to be available for investments in Australia:

- first, the availability of negative gearing is essential to create the appropriate conditions and incentives for further investment in Australia. Related to this is the fact that a substantial amount of any incentive associated with negative gearing is already capitalised in the price of the relevant assets. This means that any tightening up in this area will lead to capital losses to existing asset holders, a reduction in supply and little if any gain in taxation revenue;
- secondly, and perhaps most importantly, the fungibility of money means that it is frequently difficult to ascribe the cost of borrowing to investments in particular assets so that any quarantining mechanism will be inherently arbitrary; and,
- thirdly, any attempt to limit the availability of negative gearing for investments would create further inefficiencies and inequities in the taxation of investments and would be unworkable in any case.

In addition, the announced changes to the treatment of capital gains must be considered carefully before concluding that they represent a system that is generally more favourable to investors. The abolition of indexation meant that certain investments were actually less attractive under the new treatment.

3.1 Incentive Effects of Negative Gearing

As outlined earlier, negative gearing has the effect of reducing the effective tax rate for investors in relation to income derived from negatively geared investments. This reduction in the effective tax rate has the effect of increasing the after-tax return from negatively geared projects for investors and reducing the pre-tax rate of return required by investors when considering new investments.

Negative gearing also promotes investment by allowing businesses and individuals to gain (and maintain) access to financial markets to finance the construction or acquisition of investment assets, such as property, plant and equipment, and to fund ongoing expenditures in relation to these assets. This is because financiers are more willing to invest in projects that have a higher after-tax rate of return. On any economy wide basis, this is reflected in a greater supply of funds available for investments and a lower level of interest rates because of a lower level of risk to the lender.

Accordingly, the availability of negative gearing increases the incentive for businesses and individuals to invest in, and lenders to finance, investments. This incentive is particularly important for encouraging further investment in marginal, high-risk investments. This is because in the absence of negative gearing, the after-tax rate of return on these projects may be below the minimum threshold level necessary for them to proceed.

The importance of the incentive provided by negative gearing is clearly illustrated in the property market. In the commercial property market, negative gearing has the effect of enhancing the supply of rental property and limiting the cost of rental accommodation. This is particularly important as accommodation is a major input cost for businesses. In this regard, negative gearing improves the competitivess of Australian businesses and contributes to Australia's export performance.

Similarly, in the residential property market negative gearing has the effect of increasing the supply of rental property and limiting the cost of rental accommodation. Negative gearing is particularly beneficial in enhancing the availability of low and medium cost rental property for people who are not in a position to purchase their own home, as well as reducing the cost of such accommodation.

In the absence of negative gearing, investment in residential rental property would decline, rents would rise and governments would be under pressure to increase the supply of low-cost housing to accommodate low-income families. Accordingly, the availability of negative gearing reduces the need for Government expenditure on low-cost housing, as well as the associated administrative and infrastructure costs.

The provision of any incentive can become capitalised in the value of the assets affected by the incentive. This means that the benefits of the incentive do not necessarily accrue to the current owners of assets but instead result in higher values for the assets affected. Any change to the taxation treatment would then lead to a fall in demand for those assets and hence to a fall in asset prices. This would affect all holders of assets, not just those affected by negative gearing. The impact would be that holders of assets would face unrealised capital losses that could be significant. Falling asset prices would also discourage further investment as the lower price of existing assets would make investment in new assets less attractive.

Moreover, this would not lead to any increase in taxation revenue. Depending on the rate at which unrealised losses were crystallised through disposals, there could well be a loss of revenue.

3.2 Adverse Effects of Limiting Negative Gearing

3.2.1 Fungibility of Debt

The restrictions imposed on the negative gearing of rental property between 1985 and 1987 attempted to quarantine the deductibility of interest outlays in relation to a particular rental property to the income flows from that asset during the year. That is, these restrictions effectively attempted to limit the gearing of taxpayers in relation to:

- particular classes of investments; and
- particular time periods.

Some have suggested that such restrictions are justified (and should be re-introduced) because negative gearing creates biases in favour of investments that yield a higher proportion of capital gain rather than income, such as rental property. It is argued that such biases are undesirable because of the deferred taxation of capital gains in Australia. However, any attempt to quarantine interest deductions to income flows derived from particular **classes of investments** is unlikely to be effective due to the fungibility of debt.

As debt is fungible in nature, it makes little difference to a taxpayer whether a particular investment or class of investments is funded by debt or by the existing capital structure of the taxpayer. Rather, it is the overall leverage of the taxpayer that is relevant in determining the access of the taxpayer to financial markets.

Accordingly, any limit on the leverage of a taxpayer in relation to a particular asset or class of assets could easily be circumvented. For example, the taxpayer could simply reduce the borrowings associated with a particular class of assets (say rental property) and correspondingly increase the borrowings associated with another class of assets (such as shares), not subject to the quarantining.

Further, any restrictions on negative gearing are likely to create further inefficiencies and inequities in the taxation of investments.

For example, as outlined above, taxpayers could easily circumvent restrictions on negative gearing by adjusting the borrowings associated with particular classes of assets. This sub-optimal matching of assets and liabilities may result in inefficiencies in the form of increased financing costs for investors and unduly high transaction costs. These additional costs are likely to adversely affect the level of investment in the affected class of assets and could also result in a misallocation of resources.

Further, the introduction of restrictions on negative gearing would be inequitable in terms of both horizontal and vertical equity, as they would disproportionately impact the average investor, rather than high-wealth individuals. This is because high-wealth individuals would find it easier to re-adjust the matching of their assets and liabilities to circumvent the negative gearing restrictions, due to the greater quantum and range of their assets.

For example, if the negative gearing restrictions are applied to rental property only, those high-wealth individuals with substantial share portfolios, as well as rental property, could easily avoid the restrictions by transferring the debt attached to their investment property to their share portfolios. By contrast, the average investor with a rental property and no other investments would not be able to shift his or her investment property debt to other assets, and would therefore, be worse off.

High-wealth individuals would also have a greater capacity to absorb the substantial transactions costs necessary to re-adjust their investment portfolios.

Even if the restrictions on negative gearing applied to virtually all assets, high wealth individuals would be the least affected. This group of taxpayers tends to earn a much higher proportion of its income from capital rather than from personal exertion. This income will include interest, dividends and rent as well as the proceeds from the disposal of assets. A clamp down on negative gearing would require more careful planning of financing options but need have no impact on the overall tax position of the taxpayer. This is because taxpayers in this position are likely to have a need for current income for consumption purposes and hence would not be able to be in an overall position where deductions exceeded income.

Similarly, there is little justification for limiting interest deductions to income flows from particular investments in **particular time** periods. This is because, as outlined in APC:

"Interest may be better not viewed simply as a cost of earning current income. It is perhaps better viewed as the cost of maintaining access to the capital funds underlying a business (that is, to earn assessable income broadly defined to include capital gains)."

3.2.2 Simplicity

The introduction of restrictions on the negative gearing of particular classes of assets would greatly increase the complexity of the tax treatment of these assets and increase investor's compliance costs.

The restrictions imposed on the negative gearing of rental property between 1985 and 1987 were very complex in their implementation and involved very high compliance costs relative to the revenue raised from the measures.

A simpler tax system is essential so that the law can be understood by the taxpayers to whom it applies. A simpler tax system will also mean that fewer resources will be devoted to socially unproductive activities such as tax planning and tax litigation.

Measures that applied comprehensively to all assets would not solve the problem of complexity. Such a system would need to incorporate the carry forward of any excess interest costs and would then require rules on when the carry forward interest could be used. Presumably, the simplest system would allow the excess interest to be offset against any capital gain. Again, this quarantining would be unlikely to have much impact on high wealth investors. They are likely to have more frequent realisations so that the quarantining of excess interest costs would have less of an impact, although with greater complexity.

3.2.3 Cash Flow Problems

As outlined earlier, a negatively geared investment is structured so that in the early years of the investment the loan repayments exceed the current income from the investment and the taxpayer incurs a loss. This loss can be claimed by the taxpayer as a deduction against the taxpayer's assessable income from other sources, such as salary and wages income.

By contrast, in the absence of negative gearing, the negatively geared investor would continue to incur an annual loss, but would not be entitled to a present deduction for the loss. As a result, the taxpayer's overall taxable income (and tax payable) would be greater than it would have been if negative gearing were permitted.

This higher effective tax rate would constitute a significant disincentive to investment, as many businesses would no longer have the capacity to invest in a manner that was cash flow effective. That is, many investors could not afford to continue operating without some form of cash flow from their investment.

Further, the inability to negatively gear investments would effectively postpone for some years the deduction in respect of the loss. Due to the time value of money, a deduction for interest in the current year is more valuable to the investor than the deduction of the same amount of interest in future income years. Accordingly, the deferral of the deduction for the loss would adversely affect the real after-tax rate of return for negatively geared investors. This lower real rate of return would be reflected in a lower level of investment.

3.2.4 Investment in Property is Already Heavily Taxed

Real property is heavily taxed in Australia in comparison with comparable jurisdictions and relative to other investments. Investments in real property are currently subject to a raft of State and Territory taxes including, Stamp Duty on transfers or conveyances of property and mortgages, Land Tax, Financial Institutions Duty and Bank Account Debits Tax, as well as local government rates and other charges.

These taxes are "discriminatory" in the sense that as a class of assets, real property bears a significantly higher rate of tax than other classes of assets. This lack of tax neutrality distorts decision making and the flow of investment capital to the real property market.

Further, as many of these taxes are imposed on a transaction basis, they create market place inefficiencies by distorting the behaviour patterns of property owners by the so-called "lock-in" effect. That is, the amount of tax payable is a significant factor in the decisions of the owners of real property to acquire or dispose of an existing property.

In this context, any attempt to limit the negative gearing of property investments would add to the substantial existing tax-induced distortions inhibiting further investment in the property sector.

3.3 Relative Attractiveness of CGT Changes

Until 1 October 1999, investors benefited from indexation in determining the amount of assessable capital gain. Thus, for an asset that increased in value by 5% in a year in which inflation was 2.5%, the amount of the gain brought to tax would only be 50% of the nominal gain. Thus, for assets increasing in value at a modest rate, the proposed measures are no more favourable than the earlier treatment of capital gains.

In essence, the changes did not represent any additional concession to the treatment of capital gains except in conditions where the increase in the value of the asset substantially exceeds the rate of inflation. In particular, the changes did not represent a significant concession to real property or to income stocks. The benefits accrued to growth stocks and to higher risk equities such as in high technology and other venture capital activities.

3.4 Other Arguments

In addition, there are a number of other reasons for the continued availability of negative gearing of investments. In particular, the role of negative gearing as an inducement for further investment in Australia's infrastructure is discussed below.

3.4.1 Investment in Infrastructure

In arguing for restrictions on negative gearing, concerned parties tend to focus on the potential gains available to high-wealth individual investors, rather than looking at the larger economic picture. Tax incentives are an important tool that government can use to intervene in the market to deal with market failures (e.g. where there are positive or negative externalities associated with a particular market outcome) or to achieve social objectives.

In this regard, negative gearing is an important incentive for further investment in Australia's infrastructure, including that provided by the property sector. Negative gearing must continue to be available for future infrastructure investment, as it is important for:

- the viability of proposed large infrastructure projects;
- to encourage projects that produce positive externalities; and
- the international competitiveness of Australia's infrastructure.

The infrastructure industry is a major contributor to economic growth and living standards and a major source of demand for many commodity areas including mining, electricity and gas, transport and communications, petrol and coal, as well as the wider economy.

Good infrastructure is the mark of a developed nation and is crucial in attracting foreign investment, as well as local investment. Infrastructure industries improve rates of productivity growth, support rising real wages, drive export expansion and create and extend competitive advantage. Accordingly, continued investment in infrastructure is fundamental to Australia's future economic growth.

In this context, the availability of negative gearing can significantly change the cost and availability of funds for, and the expected after-tax returns from, infrastructure investments. The availability of negative gearing for infrastructure investments reduces the pre-tax rate of return required by investors and thereby encourages further investment in infrastructure.

The negative gearing provisions are also particularly important in offsetting, to a certain extent, various tax and non-tax distortions arising due to the inherent characteristics of infrastructure projects.

For example, the development of long-lived depreciating assets, such as large-scale infrastructure projects, requires substantial up-front capital expenditures and involves long construction periods and deferred cash flows. Further, commercial reality dictates that debt funding is required to construct or acquire these large infrastructure projects.

Without the benefit of negative gearing, tax deductions in later years will have limited value due to the effect of discounting and businesses and individuals would favour appreciating assets as against long-lived depreciating assets.

The removal of negative gearing would impose a heavier tax burden on the infrastructure industry, reducing the rates of return for infrastructure projects. This would result in lower levels of investment in infrastructure and a decline in the general level and quality of infrastructure provided, increasing costs for industry in general. In that event, Australia may find it harder to attract mobile international capital. This would inevitably lead to detrimental economic effects, with a corresponding effect on employment and the nation as a whole.

The international competitiveness of the infrastructure industry is particularly important to Australia's export performance and to Australia's position as a preferred corporate headquarters for the Asia-Pacific region. Without modern and efficient infrastructure Australia would not be competitive in this role, leading to a significant economic impact and loss of employment opportunities in Australia.

Further, the continuing establishment of Australia as a regional financial centre requires substantial communications and property infrastructure commitments in order to accommodate growth. Without these facilities, Australia would be unable to offer the required facilities to multinational businesses, with consequent effects on the wider Australian economy and business.

These arguments are equally relevant to other forms of long living assets that are crucial to delivering social benefits, such as residential and property development.

Appendix 5:

Solutions for Targeted Affordable Housing

Providing Affordable Housing

A position paper offering a public-private solution to the lack of affordable housing for Australians in our cities

CONTENTS

EXECUTIVE SUMMARY

HOME OWNERSHIP - AN AUSTRALIAN DREAM?

INADEQUACIES OF CURRENT APPROACHES

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CONCLUSION

APPENDIX A - ABOUT THE PROPERTY COUNCIL OF AUSTRALIA

"The current ad-hoc approach of Governments to urban policy has failed to deliver affordable housing to many Australians. This paper offers a solution that will give more Australians the opportunity to realise their dreams to own their own homes."

- Peter Verwer, Chief Executive Officer, Property Council of Australia, August 2002

Much has been said about getting institutional investment into affordable housing, but little has been done.

Meanwhile, the dreams of Australians to own their homes are becoming increasingly difficult to achieve.

Home ownership in Australia is in gradual decline. In 1999-2000, only 38% of Australians owned their homes outright.[10] Outright ownership has declined from 40% in 1997-98, and declined an additional 2% from 1995-96.[11]

Housing costs are increasing. The number of households in the lowest income brackets spending in excess of 30% of their income on housing (a common measure of 'unaffordable housing') is increasing. Meanwhile, the challenge of purchasing a home has increased, despite historically low real interest rates and strong economic performances since 1992.

The Property Council of Australia[12] believes affordable housing is a vital ingredient in successful and dynamic cities. Successful cities are a magnet for capital and talent. This is why the Property Council is recommending a solution to the affordable housing problem that the public sector is unable to address on its own.

Current public sector strategies to make houses more affordable are failing to meet demand. At a Federal level, the current Commonwealth - State Housing Agreement is adding an inadequate 5000 dwellings each year,[13] while there is a shortage of an estimated low-cost rental dwellings in Australia to the tune of at least 150,000 dwellings.[14] The direct cost to Governments of a resolution of the affordable housing shortage through the construction of dwellings has been estimated at $27 billion – this is unlikely to be feasible for the public sector given the current budgetary and political environment.[15] Local Government strategies have also failed to deliver affordable housing often because of the increased costs placed on developers - which are eventually imposed on property purchasers.

The answer to the problem of inadequate supply of affordable housing is to identify an innovative method of securing more private sector investment in affordable residential housing, by harnessing the power of the large institutional funds markets.

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[10] ABS Survey of Income and Housing Costs 1999-2000.

[11] ABS 4130.0 Housing Occupancy and Costs, Australia 15/10/99

[12] See Appendix A for additional information on the Property Council of Australia.

[13] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 23.

[14] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 11.

[15] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 22.

Australia's $532.4 billion in superannuation assets are growing at around 5% each year.[16] However, few of these funds flow into residential property.

After evaluating a number of proposals presented in public debate on affordable housing, this paper presents a model that uses the proven vehicle of a listed property trust to secure the private sector investment needed in affordable housing.

The model provides the following benefits:

- the model leverages the value of every dollar of public money spent – in the example used in this paper, it can translate a $30 million dollar public contribution into an $840 million pool of affordable housing assets;
- the listed housing trust model gives people equity in their homes instead of simply paying dead rent money;
- it removes the distinction between lower quality housing for the poor and better quality premises for the rest in society;
- the model supports households that are at the financially difficult stage of juggling the expense of a young family with the desire for home ownership; and,
- the proposal reduces the massive maintenance costs associated with affordable housing by giving people a reason to look after premises they can one day own.

A listed housing trust (LHT) is a publicly listed vehicle that attracts private sector funds by offering stable and attractive returns.

Instead of using public money to buy and administer stock specifically built for lower income earners, public money is used to attract institutional investment into a listed vehicle that delivers high quality housing at affordable rents.

In the LHT model used in this paper, every $1 of taxpayer's money converts to $28 that can be spent on affordable accommodation.

The LHT is designed to achieve the following benchmarks:

- deliver accommodation to tenants at affordable rates;
- deliver returns that will attract large sums of private sector money, particularly from institutional investors;
- provide tenants with an opportunity to purchase their homes, thereby decreasing wear and tear and releasing further funds to be spent on new affordable housing;
- deliver a sizeable increase in the supply of good quality new accommodation that meets the affordability criteria; and,
- divert a portion of public funds from the inefficient construction of affordable housing to a vehicle that can deliver 'more bang for the public buck' by using rent subsidies to attract private sector capital.

[16] Australian Prudential Regulation Authority, http://www.apra.gov.au/Statistics/Superannuation-Market-Statistics.cfm

AFFORDABLE HOUSING: HOME OWNERSHIP – AN AUSTRALIAN DREAM?

Home ownership is becoming an increasingly difficult dream to realise for many Australians.
In 1999-2000, 71% of Australians lived in their own homes.[17]

However, only 38% owned their homes outright.[18] Outright ownership has declined from 40% in 1997-98, and declined an additional 2% from 1995-96.[19]

The challenge of purchasing a home has increased, despite historically low real interest rates and strong economic performances since 1992. House prices and rents have increased since that time at rates well above inflation and income growth. These have been driven by the economic success of cities, migration, and real wages growth. The result has been more expensive housing.

One impact of more expensive housing is the increase in the number of households privately renting. Over the five years to 1996 the private rental market in Melbourne grew 11%, while in Sydney it grew 20%. This does not include the public housing sector.

Another related impact of more expensive housing is an increase in what is termed "housing-related income stress". This is the result of spending a high proportion of a relatively low income on housing. The ABS has measured housing related income stress identifying those households in the bottom two income quintiles which spend more than 30% of their income on housing costs.[20]

The ABS has analysed the incidence of housing related income stress and reported:

Some household types were more likely to experience housing-related income stress than others.

Lone parents were at greatest risk, with 31% of these households experiencing such stress, closely followed by private renters (30%). Other households at high risk included young households in which the reference person was under 25 (24%) and lone persons (17%). Households receiving a government pension or benefit as their main income were also more likely to experience such stress (21%), reflecting the relatively low incomes of this group.

While households in capital cities accounted for 57% of those with housing-related income stress, households outside the capital cities were over represented among those under stress: these households made up 37% of all households compared with 43% of those experiencing housing-related income stress.

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[17] ABS Survey of Income and Housing Costs 1999-2000.

[18] Ibid.

[19] ABS 4130.0 Housing Occupancy and Costs, Australia 15/10/99

[20] See National Housing Strategy 1991, The Affordability of Australian Housing, Issues paper no. 2, AGPS, Canberra

Their lower incomes might help account for their increased likelihood of experiencing such stress (12% compared to 9% of those in capital cities).[21]

It is clear that housing stress has a higher incidence amongst those who could be disadvantaged in our community.
The Affordable Housing National Research Consortium conducted a comprehensive analysis of housing stress in Australian cities, focusing on Sydney, Melbourne and Adelaide. It concluded that for low income private tenants in June 2000:

- no households can affordably buy a three bedroom house in any metropolitan location;
- 39% of Adelaide's and 15% of Melbourne's salient households can afford to buy a one bedroom unit in North Adelaide and South East Melbourne (resp.), with no households in Sydney being able to affordably purchase any dwelling in any location;
- only 9% of Melbourne's, and 3% of Sydney's salient households can afford to rent a three bedroom house in South East Melbourne and Outer Western Sydney (resp.), with no households being able to rent a three bedroom house in any Melbourne location;
- over 50% of salient households from each capital city can afford to rent a one bedroom unit in the outer locations (North Adelaide, South Eastern Melbourne and Outer Western Sydney);
- a very small proportion of households are able to afford to rent a one bedroom unit in inner Melbourne or Sydney locations (5%, Inner Melbourne only); and 38% of households can afford the rent of a one bedroom unit in Eastern Adelaide.22

Housing stress increased substantially for low income tenants between 1986 and 1996, increasing from 64.1% to 72.7% across the seven capital cities in Australia.[23] This has resulted in an estimated 227,480 private rental households in Australia being in 'housing stress'.[24] The consortium went further to forecast:

If the rate of growth of stressed households experienced in the last 10 years continues, then the number of households experiencing stress in metropolitan Australia will double in 15 years and reach nearly one million within 20 years. This does not include households struggling in regional Australia.[25]

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[21] ABS, Australian Social Trends 2000, Housing - Housing Costs.

[22] Affordable Housing National Research Consortium, Stage 1 Report – Outlining the Need for Action, Sep 01 at page 11.

[23] Berry M, New approaches to expanding the supply of affordable housing in Australia; an increasing role for the private sector, Paper presented to National Housing Conference 2001, 24-26 October 2001, Brisbane Australia

[24] See footnote above.

[25] Affordable Housing National Research Consortium, Stage 1 Report – Outlining the Need for Action, Sep 01 at page 13.

Professor Mike Berry has identified costs associated with decreasing affordability of housing in Australia:[26]

- Housing related financial hardship or poverty;
- Overcrowding and homelessness;
- Health problems;
- Family instability and breakdown;
- Reduced employment opportunities;
- Poor educational attainment;
- Increasing crime; and
- Sociospatial polarisation at the regional level – i.e. increasing social exclusion that undercuts the normal social linkages that hold a community together and provide a necessary base for economic and social life.

The implications of declining affordability and the associated increase in housing related income stress are that there is a need, on social and economic grounds, to consider strategies to provide affordable housing for Australians to realise their dreams to own their home.

[26] Berry M*, New approaches to expanding the supply of affordable housing in Australia: an increasing role for the private sector,* Australian Housing and Urban Research Institute, May 2002

The decline in the availability of affordable housing in Australia has occurred despite the three tiers of Government adopting strategies to make housing more affordable.

Federal and State Governments

The Federal Government works with State Governments to deliver public housing through a Commonwealth-State Housing Agreement. The purpose of the agreement is to provide funding to assist those whose needs for appropriate housing cannot be met by the private market. 5.6% of Australians live in a property owned by a State or Territory housing authority.[27]

Between 1 July 1999 and 30 June 2003, the agreement will provide more than $4 billion for housing assistance such as public and community housing, indigenous housing, crisis accommodation, and home purchase assistance.[28]
Notwithstanding this funding, state housing systems are struggling to meet demand. The Australian Housing and Urban Research Institute identified several reasons why state public housing systems were under stress:[29]

- falling rental income;
- potentially huge costs to maintain and refurbish ageing stock;[30] and,
- the need for major adjustments to take account of the fact that higher rates of marital breakdown, smaller families and population ageing are changing the type of housing needed.

Due to dwindling funding in real terms, the addition to housing stock each year from the agreement is estimated to be less than 5000 p.a.[31] Meanwhile, the shortage of low-cost rental dwellings in Australia was estimated at 150,000 in the mid 1990s.[32]

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[27] ABS Housing – Home ownership and renting, see Survey of Income and Housing Costs 1999-2000

[28] [insert Govt website]

[29] Media release, *Affordable housing a major challenge for Australia*, Australian Housing and Urban Research Institute, 6 September 2001

[30] The Western Australian Government has estimated that WA needs at least double the amount of funding for public housing than it receives now just to keep public housing stock at the same proportion of total housing stock: Media Release, *Commonwealth-State housing agreement push*, Hon Tom Stephens MLA, 24 October 2002.

[31] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 23.

[32] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 11.

AFFORDABLE HOUSING: INADEQUACIES OF CURRENT APPROACHES

The cost to Governments of a resolution of the affordable housing shortage through the construction of dwellings has been estimated at $27 billion – this is unlikely to be feasible for the public sector alone given the current budgetary and political environment.[33]

The Federal Government also provides rental assistance for private rental accommodation to pensioners, allowees, beneficiaries and family payment recipients who pay rent above a threshold level. The capped assistance is available at a rate of 75 cents per dollar paid.[34] The Affordable Housing National Research Consortium, while acknowledging the valuable roll of rent assistance, found that the program is not equitable, as it provides for only some of those needing rent assistance and is a flat rate, giving the same dollar amount of assistance to recipients whether in Sydney or in Hobart.[35] Professor Barry from the Australian Housing and Urban Research Institute said that high housing costs have diminished the 'buying power' of the Commonwealth's rent assistance program.[36]

The Federal and State Governments also combine to deliver a First Home Owner Grant. This was increased from $7000 to $14,000 for the purchase of new properties for a period following the introduction of the new tax system, but has now been revised to the original level (the same as existing homes), from 1 January 2002. The additional subsidy had the effect of bringing forward purchasing decisions and was a positive once-off step that added to housing stock supply at the time that the GST was introduced. However, the subsidy has not been, nor will it be, a long term solution to the alleviation of housing stress for many Australians. The Property Council suggested elsewhere that the first home owners scheme could be refocused, with funds being used instead for the subsidy required for the listed housing trust proposal to work (discussed later) which will deliver more affordable housing for Australians.

These schemes supplement other housing support strategies of State Governments. These include indigenous housing assistance, programmes for people with mental illness, crisis accommodation, home loan subsidy schemes for Government employees and bond assistance.

Notwithstanding some success, these schemes have not alleviated the shortage of affordable housing in Australia.

[33] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 22.

[34] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 20.

[35] Affordable Housing National Research Consortium, *Affordable Housing in Australia: Pressing Need, Effective Solution*, September 01 at page 22.

[36] Media release, *Bond scheme could encourage private sector to invest in affordable housing*, Australian Housing and Urban Research Institute, 25 October 2001

Local Governments

Local Governments have also taken steps to encourage affordable housing.[37] These can be categorised into:

- Incentive mechanisms
- Mandatory quotas
- Impact levies

We can consider these separately.

Incentive mechanisms

These relate to the promotion of increased housing supply by direct encouragement to developers. Generally, these utilise local governments' ability to exercise some flexibility in applying in development standards. This approach has traditionally been applied to redevelopment for residential purposes. However, more recently, this has been applied to non-residential development which raises further concerns about demand and how such demand can be satisfied.

Specifically, incentive mechanisms may include:

Density bonus – this enables a developer to increase the density beyond the established density permitted under the zoning where affordable housing is provided. For example, residential design codes in Western Australia allow for a density bonus for single bedroom dwellings or aged or dependent person dwellings.[38]

Density maximisation – the maximum permissible site density is established by the council based on environmental capacity. To achieve this density, the applicant must demonstrate that both the environmental considerations will be satisfied and that a specified amount of affordable housing will be provided. Monetary contribution may be made in lieu of direct on-site provision. These provisions would be embodied in a local environment plan with the incentives structured so as to be attractive enough to promote such development without over development.

Flexible application of development standards – councils may exercise discretion in the application of development standards (such as car parking, landscaped area, setbacks, height and the like) where affordable housing is included as part of a development. This can cause a conflict with planning objectives (eg limitation of shadowing) and affordable housing goals.

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[37] For a more expansive discussion see Gunn B of Scott Carver Pty Ltd, *Affordable Housing and the Development Industry*, Property Council of Australia (NSW Division), December 1999.

[38] Western Australian Planning Commission, "Residential Design Codes of Western Australia", October 2002.

Any relaxation of planning standards should not be to the detriment of the quality of the project generally or the surrounding environment.

Transferable development rights – floorspace or other development rights may be permitted to be transferred from one site to another, or be bought and sold in return for the provision of affordable housing. This may be used in conjunction with other incentive based mechanisms although this process requires careful administration.

Mandatory quotas/inclusionary zoning

This is more commonly known as "inclusionary zoning" and is expressed through the zoning provisions which require developments to incorporate a proportion of affordable housing.

Inclusionary zoning is a type of benefit tax which seeks to obtain planning gain through the "up zoning" of land or where the development potential of land has been increased through planning change. This has occurred in various areas in NSW such as Green Square, Ultimo Pyrmont and Meadowbank where under-utilised or redundant industrial land has been rezoned to encourage redevelopment through a broadening of the land use base and the offer of other development incentives (such as bonus floor space ratio).

While the principle of inclusionary zoning is simple, the rezoning of land establishes the new value which may be captured by the owner who sells the property before the public gain (i.e. affordable housing) is provided. Alternatively, the gain can be captured by the second owner. Further, while inclusionary zoning enables councils to seek planning gains through up zoning, there is no equivalent provision to compensate owners through down zoning.

Impact levies

Impact fees are levied through the development approval process where it is predicted that the proposed development will increase the need for affordable housing or result in a reduction in the supply of affordable housing in the area. Developers may be required to provide contributions in cash or in kind to offset the "impact" of the development. Levies of this nature are unlikely to be allowed in some States.[39] These levies are counterproductive, as they increase development costs and will not be successful in increasing the supply of housing in the longer term.

Development "linkage fees" are commonly used in the US where it can be demonstrated that there is a linkage or nexus between the proposed development and the need for affordable housing (or some other planning strategy such as the provision of public transport). Such fees are often used in areas undergoing major redevelopment.

[39] In WA, it is unlikely that such a contribution could be levied: City o f Subiaco, Social Housing Policy and Initiatives, 19 December 2000

Recent evidence suggests that many impact fee programs have been proven to be invalid due to the lack or nexus between the proposed development and the program for which the funds were to be used (such as affordable housing).

Penalty contributions are a more specific type of impact levy used by councils in NSW (such as North Sydney and Waverley) that require the payment of a contribution from a developer where it is anticipated that a development will result in a loss of affordable housing stock. In general, this approach has only been used in areas where there has been a loss of currently available affordable housing, and has not been used where demand for affordable housing is likely to increase. This mechanism has been supported by the Land and Environment Court in NSW.

The strategies adopted to date by Local Governments have not resulted in substantial gains in the supply of affordable housing. Levies, penalties and fees on developers fail in the longer term because they ultimately result in increased costs and reduced supply of housing - tightening the overall housing market as developers will redirect funds to other Councils, interstate or overseas investment opportunities. Even if development proceeds with these additional cost burdens, the levies will add to costs for the developer, which means that the final price charged to consumers is likely to be higher. Indeed, this has happened in Sydney. Instead, local governments should be looking at cutting costs to property developers and investors.

AFFORDABLE HOUSING: POSSIBLE PUBLIC PRIVATE SOLUTIONS

It is evident that current strategies of the three tiers of Australian Governments have been unable to meet the growing demands for affordable housing. Given expected pressures on public sector budgets, with an ageing population and electorates demanding increased public services, it is unlikely that the public sector alone will be able to deliver affordable housing for all Australians.

Similarly, the private sector is not currently delivering sufficient affordable housing to the marketplace. Private sector involvement in the affordable residential market is mostly limited to small property investors, in what has been termed *"a disparate and fragmented 'cottage industry'"*.[40]

Nevertheless, the private sector has demonstrated that it can be a major supplier of capital in the commercial property sector. There is no reason why the private sector, supported by public sector, could not be used to increase the supply of affordable housing. The answer to the problem with the supply of affordable housing is to identify an innovative method of securing more private sector investment in affordable residential housing, by tapping the large institutional funds markets.

There is a large and growing pool of superannuation funds. In March 2002, Australia's 237,144 separate superannuation funds managed $532.4 billion in assets.[41] Superannuation funds are currently growing at a rate of over 5% per annum.[42] Superannuation now comprises around 30% of all financial sector assets.[43] 5% of these funds are allocated to direct property investments, valued at over $28 billion.[44] A substantial percentage of superannuation funds are also invested in equities which incorporate listed property trusts, a sector valued at more than $19 billion.[45] Almost 20% of superannuation funds are now invested offshore.[46]

However, the superannuation funds direct little of this funding into residential property. Yields on residential property do not compare favourably with those in commercial property – which includes office, retail, industrial and leisure sectors. Professional and institutional investors have avoided the residential property investments because of risks that have exceeded the expected returns.[47]

[40] Affordable Housing National Research Consortium, Stage 1 Report – Outlining the Need for Action, Sep 01 at page 13.

[41] Australian Prudential Regulation Authority, http://www.apra.gov.au/Statistics/Superannuation-Market-Statistics.cfm

[42] Ibid.

[43] Ibid.

[44] Ibid.

[45] Australian Stock Exchange – www.asx.com.au

[46] Australian Prudential Regulation Authority, http://www.apra.gov.au/Statistics/Superannuation-Market-Statistics.cfm

[47] Berry M*, New approaches to expanding the supply of affordable housing in Australia: an increasing role for the private sector,* Australian Housing and Urban Research Institute, May 2002

The question for policy makers is how to either lower the risk and/or increase the returns on residential property to attract private sector institutional investment in affordable housing.

Below, the paper first considers several options that have been presented as solutions by the Affordable Housing National Research Consortium after a comprehensive assessment of a wide set of delivery mechanisms for the supply of affordable housing.

The preferred options identified by the Consortium were:

Option 1. A direct government subsidy for private (debt) investment in affordable housing. Governments would raise finance for affordable housing through the issue of a bond with a guaranteed minimum after-tax return. The funds would then be distributed to State housing authorities or other eligible housing providers (e.g. community housing providers) on the condition that they are used to construct affordable rental dwellings. The dwellings would then be owned and managed by State housing authorities or other approved providers. The subsidy could be provided in two ways: via a tax concession, or through a Budget outlay. On the measures of efficiency and equity and effectiveness, Option 1 rates very highly. This option removes most of the risks perceived by institutional investors by transferring them to the government. Based on the Commonwealth's preference for outlays rather than tax expenditures when providing assistance, a Budget outlay, which can be capped, is the proposed delivery method. Option 1 achieves a high score as it ranks favourably against the majority of assessment criteria.

Option 2. The establishment of a stock exchange listed company as a vehicle for private sector investment in affordable housing. The company would invest in affordable housing with its funds drawn from three sources: 20% Commonwealth Government equity, 30% private sector (debt and equity) investment and 50% borrowed funds.

The Commonwealth Government's investment in the company would be in the form of subordinated equity that would be available to meet investors' returns, up to a predetermined level designed to encourage private investment.

Option 2 scores well on efficiency and equity grounds. It addresses the identified shortage of affordable rental housing through the provision of funds for the construction of new dwellings. However, on the matter of risk, the possibility that the Commonwealth could lose its equity and the parallel risk to institutions from exposure to the property market, results in a poor risk rating. The principle of a Government investing in a stock exchange company is also considered to be inconsistent with the broad thrust of Commonwealth economic policy.

Option 3. A prescribed ratio for affordable investment assets. The Commonwealth would mandate through legislation that a minimum proportion of the assets of designated financial institutions, notably superannuation funds, be held in ownership of rental dwellings managed by State and Territory Housing Authorities (or agents in the community sector). On the measures of efficiency, equity and overall effectiveness. Option 3 scores poorly. As there is no direct budget cost to government, it scores highly against the budgetary impact criterion. It is, however, out of alignment with existing Commonwealth policy on superannuation and on economic regulation generally.

In short option 3 scores poorly against the majority of criteria. Unless investment in new dwellings is made mandatory it may have little impact on the shortage of affordable housing and hence on relieving housing stress - one of the main objectives of the Consortium's approach.

The preferred option of the Consortium was option 1, which provides for a direct government subsidy for private investment in affordable housing. The scheme still relies on Government housing authorities or other approved providers to own and manage the properties and does not allow for Australians to build equity in their own homes – which is a key deficiency.

Since the Consortium's recommendations in 2001, two additional policy solutions that provide for private sector funding of affordable housing have emerged in public debate.

First, Professor Andrew Caplin and Christopher Joyce, in a paper for the Menzies Research Centre, have proposed a framework to encourage institutional private sector investment in affordable housing.[48] In essence, it facilitates the introduction of a limited equity partner [an institutional investor] to part finance the purchase of a home by the 'managing partner'. The authors presented the proposal as follows:

We propose the development of a liquid secondary market in real estate equity. Housing would be financed with both a mortgage and an institutional investor who provides equity capital for the dwelling in exchange for a fraction of the ultimate sale price, with no other monetary payments made between the parties. Here we refer to the household that takes occupancy of the residence as the 'Managing Partner', and to the financial institution that initially co-owns the asset as the 'Limited Partner' (see also Caplin, Chan, Freeman, and Tracy (1997)).

Importantly, the 'Partnership Contract' leaves the Managing Partner in complete control of the property, with the right to determine the time of sale and a strong incentive to optimise both partners' interests. It was conceived to maximize simplicity, minimize any inconvenience, and ensure that the household's day-to-day experience remained much the same.

Accordingly, it is our belief that the Partnership clauses would not be perceived as especially onerous. In fact, many of the provisions can be found in the standard Mortgage Agreement. We should also make clear that we consider the traditional mortgage and our 'Partnership Market' to be symbiotic forms of finance. Hence, we regard it as imperative to structure the agreement in a manner that enables the Partners to borrow against equity held in the dwelling. The Managing Partner might then obtain a mortgage against the value of the asset they acquired.

[48] Caplin A and Joyce C, A primer on a proposal for Global Housing Finance Reform, The Menzies Research Centre, www.mrcltd.com.au

To ensure that Limited Partnership assets are as widely held as possible, we would recommend the establishment of an active secondary market, with the domestic and US mortgage markets used as an institutional model. In short, we envision a 'specialist' buying Partnership contracts, holding them in a portfolio, and issuing shares on the underlying baskets. The specialist could choose to split up the portfolio into geographic baskets (such as by region, state, or post code) or along a variety of other dimensions.

The composition of the baskets would depend on the desires of the institutional holders of the fund shares and on any pertinent guidelines provided by policymakers. To a first approximation, the return pattern on packages of Limited Partnerships would mimic that of residential real estate, where the maturity would be uncertain because of the Managing Partner's right to select the date of divestiture.

This proposal has the potential to ensure a greater supply of affordable housing as home owners and institutional investors harness the opportunity to diversify their portfolios into the residential property sector. However, this model is likely to push up housing prices. It also requires an entirely new market to be created. The uncertainty of the payback date of the contributions would also increase risk levels and detract from the success of the scheme.

A second proposal, which uses the existing listed property trust sector as a model, is advanced by the Property Council, based on an original proposal by Mr Brendan Crotty, Australand's Managing Director. In the next section, the paper considers the model which could deliver the institutional private sector investment into affordable housing that is so desperately needed.

AFFORDABLE HOUSING: A NATIONAL STRATEGY TO DELIVER A SUSTAINABLE SOLUTION

A recent, innovative package could provide an avenue for the delivery of a sustainable solution to the growing affordable housing challenges confronting Australian society.

The model has the following features:

- it is based on property trust vehicles that are already in common use, are understood by the market and enjoy a strong track record;
- the model leverages the value of every dollar of public money spent – in the example used in this paper, it can translate a $30 million dollar public contribution into an $840 million pool of affordable housing assets;
- the model gives people equity in their homes instead of simply paying dead rent money;
- it removes the distinction between lower quality housing for the poor and better quality premises for the rest in society;
- the model supports households that are at the financially difficult stage of juggling the expense of a young family with the desire for home ownership; and,
- the proposal reduces the massive maintenance costs associated with affordable housing by giving people a reason to look after premises they can one day own.

A listed housing trust (LHT) is a publicly listed vehicle that attracts private sector funds by offering stable and attractive returns.

Instead of using public money to buy and administer stock specifically built for lower income earners, public money is used to attract institutional investment into a listed vehicle that delivers high quality housing at affordable rents.

In the LHT model used in this paper, every $1 of taxpayer's money converts to $28 that can be spent on affordable accommodation.

The LHT is designed to achieve the following benchmarks:

- deliver accommodation to tenants at affordable rates;
- deliver returns that will attract large sums of private sector money, particularly from institutional investors;
- provide tenants with an opportunity to purchase their homes, thereby decreasing wear and tear and releasing further funds to be spent on new affordable housing;
- deliver a sizeable increase in the supply of good quality new accommodation that meets the affordability criteria; and,
- divert a portion of public funds from the inefficient construction of affordable housing to a vehicle that can deliver more bang for the public buck by using rent subsidies to attract private sector capital.

What is 'affordable'?

A 'working poor' family is defined as receiving a single income equivalent to average weekly earning. It is assumed the family's overheads, excluding rent and food, are car payments of $350 per month and credit card obligations of $500 per month.

On this basis, the model assumes such families can afford rent that is equivalent to three per cent of the asset value of a home, which translates to:

Sydney: $202 per week
Melbourne: $182 per week
Brisbane: $115 per week

Traditionally, these levels of rental payment would not produce the returns that would attract private investors.

The difference between the rental yield required by the market and the three per cent that is affordable is around 3.5%.

The model proposes that governments subsidise the basic rent paying capacity of occupants with a portion of funds from the Commonwealth-State Housing Agreement.

How much rent subsidy is required?

The following funds are required per household per week to increase returns, attract funds and make each public dollar go further:

Sydney: $236 per week

Melbourne: $212 per week

Brisbane: $135 per week

The key to the listed housing trust model is to generate enough wealth to share between investors and occupants, thereby encouraging occupants to purchase their own home outright.

Distributing Wealth and Incentive

The model proposes the following annual distribution of wealth from the LHT:

Income

- 100% of income from rental payments to be distributed to the trust's unit holders.

Capital

- 70% of annual capital appreciation distributed to unit holders; and,
- 30% of annual capital appreciation distributed to the rent-paying occupant.

Assuming modest levels of gearing, the result is:

Investors - A total return of 9.7% per annum, which is quite competitive.

Occupants - An annual share of capital growth ranging from $1,800 per annum in Brisbane to $3,150 per annum in Sydney.

The share of capital growth achieved by occupants can then be directed to bridging the deposit gap and purchasing the home they live in.

What assumptions drive the model?

A $30 million rental subsidy spread evenly between the three largest capital cities could deliver 800 homes in Sydney, 900 homes in Melbourne and 1,400 homes in Brisbane, based on typical construction costs.

That is because the proposed public subsidy lifts rental yields to a point that can attract significant private sector capital into a listed trust.

In our model, based on a competitive required rate of return, the private sector could supply enough funds for an $840 million housing asset base; we have assumed the trust's assets will grow at a very conservative 3% per annum.

We have also anticipated annual rental increases of around 3%.

Clearly, the LHT could be larger with a bigger injection of public rental subsidy. In addition, several trusts could be created across the nation, including the ACT.

The model also assumes that the borrowing cost associated with new homes will be locked in for the first five years at less than 6 per cent. This is realistic given that the debt yield curve is flat – meaning there is little difference between the 180 day bank bill swap rate and the 3, 5 and 10 year swap rate.

Worked Example

Asset Base: $840 million
Gearing: 30%
Interest: <6% locked in for 5 years
Annual capital growth: 3%
Annual rental growth: 3%

Annual rent: $54.6 million
Interest payments: $15.1 million
Net rent: $39.5 million

Annual capital growth: $25.1 million
Share to investors: $17.6 million
Share to occupants: $7.5 million

Total for distribution: $39.5m (in rent)+ $17.6 m (of growth) = $57 million
Total return on equity: 9.7%

Conclusion

The listed housing trust model creates three big winners:

Governments

State housing commissions and departments are short of money. The LHT model helps solve part of the problem. In addition, these authorities have assets that are illiquid.

The LHT model provides government authorities with an opportunity to unlock their balance sheets by selling some assets into LHTs. For example, if 5% of the NSW Department of Housing's asset base of $18 billion were unlocked and securitised (or simply sold onto the open market), $900 million could be realised.

This money could then be used to fund rental tops ups, and therefore, leverage more housing, for many years.

The Community

The LHT scheme delivers a much larger supply of housing to those who cannot afford it. The housing is not built specifically for low-income earners or located in 'designated locales', it is good quality accommodation located across metropolitan areas.

In addition, the scheme gives these tenants a decent leg up to homeownership.

Investors

Investors receive quarterly distributions of attractive returns.

The income streams will be very stable, with most of the characteristics of a bond. The advantage is that there is a capital kicker like most other collective investment vehicles.

In addition, the long-term demand profile for affordable assets is strong.

In summary, this scheme promotes state based Listed Housing Trusts, subsidised by Government, as a solution to affordable housing. It differs from option 2 considered by the Consortium in the previous section because it does not propose that the Government take an equity stake in the listing housing trust. The proposal has the distinct benefits of potentially delivering home ownership and affordable housing across metropolitan areas in Australia.

Annexure A:

Recapitalising Australia's Cities: A Strategy in the National Interest (Allen Consulting Group, 2002)

Annexure B:

Urban Infrastructure Approaches Compared (Allen Consulting Group, 2003)